TECHNICAL NOTES AND MANUALS

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Fiscal Affairs Department

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Extrabudgetary Funds

Richard Allen and Dimitar Radev

This technical note[1] addresses the following main questions:

- What are the definition, classification, and typology of extrabudgetary funds (EBFs)?
- Why do EBFs exist?
- What are the problems created by EBFs?
- What are the criteria for evaluating and reforming EBFs? and
- What are the implications for analysis of fiscal policies and for public financial management (PFM)?

I. Definition, Data, Classification, and Typology of EBFs

Although the term extrabudgetary funds seems self-explanatory, in practice it refers to a diverse and often complex set of issues. Introducing a meaningful definition and typology is helpful in clarifying the concept of EBFs and distinguishing their many different varieties.

A. Definition of EBFs

The term "extrabudgetary" can be used in several ways, each emphasizing a different aspect of the issue. Extrabudgetary *transactions* are the broadest concept and include all revenues, expenditures, and financing that are excluded from the budget. Extrabudgetary *accounts* are the bank arrangements into which extrabudgetary revenues and expenditures are paid in and disbursed. Extrabudgetary *entities* (or units) are institutions that are engaged in extrabudgetary transactions, may use extrabudgetary accounts, may have their own governance structures and, often, a legal status that is independent of government ministries and departments.

In this note, **EBFs refer to general government transactions, often with separate banking and institutional arrangements that are not included in the annual state (federal) budget law and the budgets of subnational levels of government.**

The note especially focuses on institutional arrangements of EBFs when they are organized as separate government entities. However, such entities may not capture all extrabudgetary

[1]Based on "Managing and Controlling Extrabudgetary Funds" by Richard Allen and Dimitar Radev, published in OECD Journal on Budgeting, Volume 6 Issue 4, 2006; www.oecd.org/gov/budget/journal. This note benefited from valuable comments by colleagues from the IMF Fiscal Affairs Department, the World Bank and OECD, and also from the helpful research assistance of Mr. Dimitar Vlahov.

transactions. An appropriate framework for classifying and reporting EBFs is set out in the 2001 version of the *Government Finance Statistics Manual* (*GFSM 2001*).

B. Data on EBFs

Table 1 summarizes data on EBFs provided in the 2009 edition of the IMF's *Government*

Table 1. EBFs and Central Government Expenditures[1]

Group of Countries	EBFs Outlays		Social Security Fund Outlays	
	% of total outlays	% of GDP	% of total outlays	% of GDP
Developed countries[2]	12.2	3.0	36.5	9.4
Transition/developing countries[3]	9.4	2.8	25.4	7.1
All countries	11.1	3.0	35.1	9.1

Source: September 2009 GFS Yearbook CD-ROM: EBFs, social security, and total outlay data. GDP data come from the IMF World Economic Outlook (October 2009). Range of data: 2005–07 (most recent available data by country).

[1]Data from the GFS Yearbook are presented on a gross basis for all subsectors. Existing sectors correspond to those described in the institutional tables of the 2008 GFS Yearbook.

[2]Includes countries that are classified as high income according to the July 2009 World Bank Atlas Method (Gross national income per capita of US$11,906 or more). Sample of 9 countries for data on EBF outlays, 22 countries for data on social security outlays.

[3]Includes countries that are classified as low income, lower middle income, and upper middle income according to the July 2009 World Bank Atlas Method. Sample of 23 countries for data on EBF outlays, 32 countries for data on social security outlays.

Finance Statistics Yearbook.

The following conclusions may be drawn from these data:

- EBFs represent a significant part of central government expenditures. Including social security funds, they account for about 46 percent of total expenditures.[2]
- Social security funds are the single most dominant form of extrabudgetary activities, accounting for 35 percent of total expenditures.
- While the level of extrabudgetary activities, excluding social security funds, is broadly comparable for both developed countries and transition and developing countries, social security funds represent a significantly bigger portion of central government expenditures in developed countries.
- More detailed analysis of the data suggests that EBFs in many developed countries have a well established institutional framework—mainly variations of the agency model discussed in Section II below, while transition and developing countries use a wider range of arrangements, sometimes without a clear economic and legal identity.
- EBFs in developed countries are generally well integrated with the budget process—in line with the concept of the consolidated budget discussed later in this note; and in some cases

[2]Budgetary accounts reflect the EBFs expenditures to the extent they are financed through transfers from the budget.

are not presented as a separate government subsector. For example, data for EBFs for most EU member countries are presented as part of the central government budget.

C. Classification and Typology of EBFs

The consistent classification of EBFs is important to ensure that fiscal data are comprehensive and fiscal targets are properly defined. Such a classification should start from the framework of concepts and definitions for statistical reporting set out in the *GFSM 2001* and equivalent international standards. The *GFSM 2001* puts the emphasis on the economic characteristics of an entity rather than its legal form. The basic concept is that of an "institutional unit," which is defined as "an economic entity that is capable, in its own right, of owning assets, incurring liabilities, and engaging in economic activities and in transactions with other entities." The institutional unit is also characterized by "a complete set of accounts, including a balance sheet of assets, liabilities, and net worth."

The *GFSM 2001* framework allows specifically for the inclusion of EBFs within its classification system. In particular:

"There may however be government entities with a separate legal identity and substantial autonomy, including discretion over the volume and composition of their expenditures and a direct source of revenue, such as earmarked taxes. Such entities are often established to carry out specific functions, such as road construction or the nonmarket production of health or education services. These entities should be treated as separate government units if they maintain full sets of accounts, own goods or assets in their own right, engage in nonmarket activities for which they are held accountable in law, and are able to incur liabilities and enter into contracts" (paragraph 2.24).

GFSM 2001 goes further in providing relevant information that could assist users to identify and classify particular types of EBFs:

"Nonmarket nonprofit institutions that are both controlled and mainly financed by government units are legally nongovernment entities, but they are considered to be carrying out government policies and effectively are part of government. Governments may choose to use nonprofit institutions rather than government agencies to carry out certain government policies because nonprofit institutions may be seen as detached, objective, and not subject to political pressures. For example, research and development and the setting and maintenance of standards in fields such as health, safety, the environment, and education are areas in which nonprofit institutions may be more effective than government agencies" (paragraph 2.29).

Similarly, *GFSM 2001* appears to acknowledge that social security funds will sometimes (or even normally) take an extrabudgetary form since such funds must satisfy the general requirements of an institutional unit, namely "be separately organized from the other activities of government units, hold its assets and liabilities separately, and engage in financial transactions on its own account" (paragraph 2.21).

While *GFSM 2001* can help identify the economic status of EBFs and their affiliation to the government or the broader public sector, a more detailed typology might be useful for detailed fiscal analysis and presentation. To this end, EBFs can be grouped according to their: (i) objectives; (ii) sources of funds; and (iii) institutional design. Many EBFs combine items from more than one of the categories listed below.

Objectives

- **Special funds:** funds established for specified purposes and financed from special taxes or other earmarked revenues required usually by law, such as social security funds, health funds, and road funds.
- **Development funds:** funds established to support development programs usually involving donor contributions and sometimes internal sources (e.g., privatization receipts), such as social funds, environmental funds, and sectoral funds.
- **Investment Funds:** funds established with specific investment objectives and composed of stocks, bonds, property, precious metals or other financial assets, such as sovereign wealth funds.
- **Contingent (reserve) funds:** funds held for emergencies or unexpected expenditures.
- **Stabilization funds:** funds established to reduce the impact of volatile revenue on the government and the economy, such as oil stabilization funds.
- **Savings funds:** funds that seek to create a store of wealth for future generations, such as oil savings funds.
- **Financing funds:** funds used to finance the overall budget balance, and not regular expenditures, most often by utilizing oil and other nonrenewable resource revenues, such as oil financing funds.
- **Counterpart funds:** funds linked to inflows of donor aid (including in-kind) and managed under specific procedures, taking into account the requirements of the donors concerned.
- **Revolving funds:** funds that are replenished, usually through charges made for goods and services and on-lending operations, and whose income remains available to finance its continuing operations, which would otherwise be jeopardized by budget rules that require budgetary appropriations to expire at the end of the year.
- **Trading funds:** funds established to provide a financial mechanism for government trading activities on the principle of self-financing.
- **Sinking funds:** funds accumulated by a government or governmental body, usually arising from taxes, imposts or duties for the purpose of repaying a debt.
- **Miscellaneous extrabudgetary accounts, including secret funds:** held by government ministries and agencies, frequently for the hypothecated use of ministers and nominated officials.

Sources of finance

- **Earmarked revenues**: both general (e.g., defined as a percent of total revenues) and specific (identified with a specific tax or social security contributions).
- **Transfers from the budget.**
- **User charges.**
- **Sales of financial and nonfinancial assets, including privatization receipts:** usually used for one-off purposes.
- **Sales of goods and/or services.**
- **Borrowing.**
- **Donor funds:** including direct aid contributions and/or debt relief, and debt swap arrangements.

Institutional design

- **Funds managed centrally by the ministry of finance or the treasury:** the motivation for establishing such funds is, most often, to avoid the restrictions of the budget process, as, for example, in the case of centrally managed revolving funds.
- **Funds managed by line ministries and/or other spending agencies:** in addition to the motivation above, these funds may be established to avoid expenditure controls applied to budget organizations.
- **Funds managed by autonomous agencies.**
- **Funds managed by local governments.**

Many of the above activities or funds can also be organized as on-budget funds. In these cases, they are part of the budget but are earmarked for special policies and purposes. For example, all trust funds in the United States are on-budget, except the two social security retirement trust funds, which are classified as EBFs.

II. Why do EBFs Exist?

The existence of EBFs can be attributed to budget system failures and political economy factors. The budget system failures may be divided into the following categories:

- **Mismatch of time horizons.** Certain categories of EBFs—relating to social security funds, oil stabilization funds, and oil savings funds, for example—are established to provide income for pensioners or future generations, or to provide security against a change in economic circumstances, such as the decline in natural resources, in the long term. The time horizon for such funds is much longer than that for the traditional budget, which nearly always is one year
- **Interference of special interests with the budgetary process.** The misallocation of resources that results from manipulation of the budget process—too little funding for road maintenance, too much for "pork barrel" projects—often leads to the creation of EBFs that are designed to secure some measure of insulation from these practices. The basic motiva-

tion is to provide security with a hypothecated source of funding as a way of preventing too many or too few resources being allocated.

- **Inadequate mechanisms for allocating resources.** Examples include the "capture" element in the budget (civil servants setting preferences rather than these being established through the political process); conflicts that arise between the executive branch and the legislature in setting priorities and making choices between competing claims on resources; and the absence of a mechanism for reconciling the needs of the purchasers and providers of public goods and services.
- **Failure to recognize the needs of local communities in allocating resources.** Budget systems in some countries are concentrated in central agencies such as the finance ministry and the treasury with only weak mechanisms for transmitting information about economic conditions and budget priorities from the periphery to the center, and little responsiveness to local needs. In such an environment, there is an incentive for local authorities and communities to establish alternative mechanisms for meeting the budgetary requirements that are unsatisfied through the normal channels, including through EBFs.
- **Ineffective control and incentive mechanisms for public sector managers,** especially in large ministries and other organizations that may have overlapping and sometimes conflicting policies and operational goals. Many OECD countries consider the agency model as an appropriate alternative to traditional budget organization, in order to introduce or strengthen such mechanisms. Although agencies can operate within the budget system, in many cases they are organized as EBFs, which, among other things, allows them to retain and use fees and charges to finance their own expenditures, rather than transferring these revenues to the budget.
- **Unsatisfactory governance arrangements for accountability and transparency.** In particular, mechanisms for the external oversight of the budget in developing countries are frequently undeveloped. In many such countries, no independent external audit body exists, or its role and responsibilities are severely limited *de jure* or *de facto.* Similarly, the oversight powers of the legislature are frequently limited by the absence of sufficient statutory authority and resources to exercise its role effectively. Under these conditions, EBFs can be established and flourish without challenge from the oversight bodies.
- **Ineffective mechanisms for addressing donors' fiduciary requirements.** Budget support is becoming increasingly important as a way of providing aid, especially in the context of the 2005 Paris Declaration on Aid Effectiveness and the 2008 Accra Agenda for Action to accelerate and deepen its implementation.[3] However, in practice, many donors continue to use traditional funding methods that effectively ring-fence the aid funds, ostensibly to

[3]The Paris Declaration was issued jointly by the World Bank, the Asian Development Bank, the European Commission, the United Nations, the Development Committee of the OECD, and partner countries, and followed similar Declarations at Monterrey (May 2002) and Rome (February 2003). Among other elements, the Paris Declaration stated that the partners should "use country systems and procedures for planning, disbursement, procurement, monitoring, reporting, and auditing [of aid]." Indicators were established to monitor progress on this and other elements of the Declaration.

reduce fiduciary risk, and, according to the OECD 2008 Survey on Monitoring the Paris Declaration, budget support still represents only 22 percent of total foreign aid.

EBFs also arise because of political economy factors such as the following:

- **To protect politically sensitive programs from budget cuts or other short-term considerations in the context of the annual budget cycle.** The ongoing discussions on the social security reform process in the United States represent a good example. The 1983 National Commission on Social Security Reform (the Greenspan Commission) argued that "changes in the social security program should be made only for programmatic reasons, and not for purposes of balancing the budget." This, according to the majority of the members of the commission, "would be more likely to be carried out if the social security program were not in the unified budget." Eventually, the U.S. social security fund was organized as an off-budget program and included in the unified budget.
- **To give an appearance of a smaller budget deficit,** by financing certain programs outside of the budget through EBFs, even though the government still needs to finance this spending.
- **To generate political support for introducing new taxes.** For example, the establishment of a health fund, and the introduction of a health tax to finance its expenditures, could be more acceptable politically than the increase in revenues required to finance the general government expenditures, although the macrofiscal effect is equivalent. Similarly, the establishment of an environmental fund can facilitate the introduction of an environmental tax.
- **To recognize and mobilize a social consensus that certain important activities are underfunded in the annual budget.** The establishment of a dedicated road fund or an environmental fund is often considered a political act of recognition of the importance of these activities that is also appealing to broad social groups, although in practice this would not necessarily improve the financing of these activities.
- **To insulate donors' projects and programs in priority sectors at their request.** Although the economic rationale for channeling donors' aid through EBFs is generally weak, their use in specific cases may be justified on political grounds. For example, following the change of government in the West Bank and Gaza in 2006, the donor community has considered alternative options to provide financial assistance to the Palestinian people, including through extrabudgetary trust funds under the president's control, in order to insulate the government from managing foreign aid.
- **To protect funds from public scrutiny, contrary to generally accepted principles of transparency.** For example, the government of Estonia set up a privatization fund in the 1990s which made earmarked privatization receipts less evident to politicians and susceptible to spending pressures. The Kuwaiti Reserve Fund for Future Generations is prohibited by law from disclosing its assets and investment strategy. The authorities justify this

policy on the grounds that if the public knew the true extent of official assets, there would be greater pressures to spend.

In addition, EBFs are sometimes justified on the basis of the benefit principle of taxation, and, since many such funds are financed from a specific stream of tax revenues, the related principle of earmarked taxes. Social security funds, and, to some extent, public health funds, are considered the clearest example of EBFs to which the benefit principle of earmarking is applied, using the argument that the premiums (contributions) are paid by the social partners (employers and employed) and that the funds thus "belong to" these groups at least to the same degree as to the government. For the same reason, the social partners are often represented on the board of management of such funds.[4] In some countries, for example the United Kingdom, this theory has become redundant since the social security funds, once independent, have become fully integrated with the budget, and are financed on a pay-as-you-go basis by social security contributions. These contributions, while retaining their title, have thus become *de facto* part of government revenues. Nevertheless, except perhaps in the case of social security funds, earmarking is not a clinching argument for EBFs since similar political economy benefits can be achieved through the budget process.

The agency model[5] for managing public funds has also been advanced as a justification for EBFs since many agencies are set up on an extrabudgetary basis.[6] A definition of public agencies is presented in Box 1. The agency model is most commonly found in developed countries, where it has reached an advanced form, but also in some transition and developing countries. While technically agencies do not have to be constituted as EBFs, it has been argued that the potential economic benefits they bring are most likely to be realized when they are given significant financial independence, and this may be difficult to achieve if they are tied directly to the budget process.

When established as public agencies and accompanied by either administrative mechanisms or market-like incentives that promote accountability and efficiency, EBFs can lead to microeconomic efficiency gains by simulating private market conditions where levels and standards of service are linked directly to fees and charges. They can also provide a more consistent source of funding for expenditures that yield high benefits yet do not get much recognition in the budget preparation process (maintenance expenditures for capital infrastructure being a primary example). However, the freedom of action to take decisions about both operational management and the planning and use of resources, which is the hallmark of agencies, may open the door to a new set of risks if the governance and public financial management arrangements for these bodies are poorly designed.

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[4]See Kraan (2004).

[5]For a useful overview of the theory and practice of the agency model, see OECD (2002).

[6]This is consistent with the approach under ***GFSM 2001***, in which, as explained in Section II, many agencies are classified as extrabudgetary entities.

Box 1. Definition of Public Agencies

For working purposes, an agency can be defined as a body that:

- operates with some degree of autonomy from political direction;
- is established in a founding law, charter or contract;
- manages its budget autonomously, but within a framework of rules set by the government;
- is financed through a combination of own source revenues, earmarked contributions and transfers from the state budget;
- has assets that are owned by the public and may not be used for private benefit; and
- is accountable to the public, as defined by law and tradition.

Some of these features, especially items 3, 4 and 5, are also defining characteristics of EBFs.

A paper by OECD/SIGMA[7] recommends that countries should establish a comprehensive framework for the governance and financial management of their public agencies. This framework should cover areas such as: the control and management of real property assets; borrowing; revenue raising policies; earmarked contributions; budget formulation and budget approval; oversight of staffing and personnel costs; budget execution and control; performance management; accounting and reporting.

Many OECD countries have made substantial progress in developing such a framework—a good example is the regime for managing nondepartmental public bodies, formerly known as "quangos," in the United Kingdom (see Box 2). However, the progress made in most transition and developing countries has been generally less successful, reflecting in part weaknesses in their systems of public financial management. Even in advanced countries, however, the development of appropriate financial management rules for public agencies is a difficult and complex process, in which there is an inherent tension between the role of the ministry of finance, whose goal is to enforce rigorous standards of financial management, and the "parent" line ministries, who tend to advocate looser standards of control and the exercise of considerable discretion by agencies in the use and management of their resources.

III. The Potential Problems Created by EBFs

Some commentators consider EBFs to be potentially problematic by undermining the soundness of fiscal policy, fiscal discipline, and transparency. Such problems, however, are not necessarily endemic to EBFs as a category of public institution, and may frequently be attributed to poorly designed financial management and governance procedures, and a weak interface between these bodies and the budget process.

[7]SIGMA (2001). The paper sets out general principles and recommendations based on an analysis of the experience of agencies in five EU countries: France, the Netherlands, Portugal, Sweden, and the United Kingdom.

Box 2. A Governance and Financial Regime for Nondepartmental Public Bodies

According to the UK Cabinet Office, a nondepartmental public body "has a role in the process of national government, but is not a government department (i.e., ministry) or part of one and which accordingly operates to a greater or lesser extent at arms' length from ministers." Nondepartmental public bodies operate under a financial regime that allows them to operate their own budgets but subject to common standards established by the finance ministry (HM Treasury).[1] Another class of agency in the United Kingdom, the so-called "Next Steps Agencies" remains integral parts of the ministry but have substantial flexibility in budget and personnel management and separate accounting and reporting arrangements. A notable feature of the United Kingdom system is "the existence of an over-arching complex of standards that apply to …. entities within the public sector, including those with separate legal personality. The system includes rules issued by HM Treasury for accounting, reporting, audit, etc. and a Standing Committee on Standards in Public Life which promulgates governance standards and codes of conduct for board members and officers. In addition, agencies in all classes are subject to audit by the National Audit Office."[2]

[1]UK Cabinet Office (2004). See especially Paper No. (i) *Financial Management—Planning, Funding and Control.* The control arrangements include an intriguing and subtle use of incentives. For example, a nondepartmental public body spending scores against the budget appropriation of the "parent" ministry. Thus departments "must ensure that they are able to control the expenditure of their NDPBs in order to stay within their limits."

[2]SIGMA (2001).

The fiscal policy considerations mainly relate to the soundness of fiscal analysis and fiscal policy formulation. The lack of full and timely information on the activities of EBFs, as a result of their insulation from the regular budget process, can significantly distort the assessment of the overall macroeconomic and fiscal position, including with respect to critical dimensions such as: the size of the general government; its contribution to aggregate demand, investment, and saving; the tax burden; and the social safety net.

In addition, the possibility for EBFs to borrow, as in the case of some social security funds, or to implement quasi-fiscal or on-lending operations, as in the case of some revolving and trading funds, may have a significant impact on the sustainability and transparency of fiscal policies, and contingent claims against the government.

The consequences for heavily-indebted poor countries can be especially serious because EBFs may have a sizable effect on their debt position and on the effectiveness of spending related to poverty alleviation. In the wake of the multilateral debt relief initiative, an immediate issue is the need for a comprehensive debt management strategy in the countries concerned.

The inadequate transparency of some investment funds, such as sovereign wealth funds (SWFs), has been a concern for investors and regulators, especially regarding their size and source of funds, investment goals, internal checks and balances, disclosure of relationships and holdings in private equity funds. Many of these concerns have been addressed by the IMF and the International Working Group of Sovereign Wealth Funds (IWG) in the Santiago Principles,[8] which set out common standards regarding their transparency, independence and governance.

Extrabudgetary funds are also sometimes associated with the dilution of accountability and control, problems in reporting and consolidating fiscal data, the diversion of limited administrative capacity, and restrictions on modifying taxes that are earmarked for financing EBFs. Some studies[9] regard EBFs as a potential source of political and administrative corruption, and refer to cases where "little empires" have been built with public resources through the use of EBFs, and where political parties are financed through these funds.

One major risk from EBFs is their tendency to proliferate into hundreds or thousands of individual units, thus atomizing political governance and fragmenting and undermining the overall quality of public financial management. For example, the significant number of EBFs in many central and eastern European countries in the early 1990s, including in Russia, Poland, and Bulgaria, as well as in Turkey, had a damaging impact on their overall fiscal performance. The current proliferation of extrabudgetary activities through the formation of public law entities and noncommercial organizations poses similar fiscal risks in countries such as Georgia and Armenia. Ghana is another example of a country with a plethora of statutory funds in sectors such as roads, social security and mining, that have had an adverse impact on overall budget management.

Specific PFM problems may arise from the use of EBFs in managing donor aid funds. Despite the increased role of budget support in providing donor aid, as indicated above, extrabudgetary transactions are still widely used in managing donor contributions. Many donors feel comfortable with such arrangements because they are accountable to their own taxpayers and in their view EBFs are likely to be better managed than the general budget and can yield better results and outputs. However, from a strategic point of view, such an approach may have a negative impact on the development of a national public financial management system. The creation of "islands of excellence" rarely leads to a general improvement in management capacity, and indeed may serve to erode effectiveness elsewhere in the system, for example by diverting scarce skilled staff from civil service positions and distorting wage structures.

IV. Criteria for Evaluating and Reforming EBFs

The following criteria may be useful in evaluating whether a country's EBFs should continue to exist, be commercialized or privatizalized, or be abolished:

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[8]For detail see Sovereign Wealth Funds: Generally Accepted Principles and Practices, "Santiago Principles", October 2008.

[9]Allen and Tommasi (2001).

- Is there a satisfactory economic, governance and political economy case for establishing the EBF? If so, is it possible to consolidate information from the EBF with fiscal tables for the purposes of budget preparation and macrofiscal analysis?
- Is the EBF properly classified according to the guidelines in *GFSM 2001*? If so, are the procedures for preparing and executing its budget, and financial reporting, comparable to the government's overall framework for managing budgetary expenditures and revenues?
- In cases where the EBF is financed by earmarked taxes, are the arrangements for collecting these revenues satisfactory and compatible with the overall efficiency of tax policy and tax administration?
- Is the legal basis for the EBF adequate in terms of financial management and reporting?
- Is the governance structure of the EBF (e.g., role, responsibilities and independence of the board, transparency of the decision-making process, etc.) compatible with the objectives of sound financial management?
- Is the EBF's budget presented to the legislature in parallel with the state budget and subject to a similar process of scrutiny? If so, how integrated is the EBF with the fiscal objectives of the government?
- Is the EBF's budget subject to audit by the Supreme Audit Institution according to a comparable process and timetable as the general budget?

Evaluation of country experience suggests that many EBFs are unlikely to satisfy all the criteria set out above, especially in transition and developing countries in which the basic governance and financial infrastructure is weak. However, as noted above, many OECD countries have allowed and even encouraged EBFs to exist alongside a strong regime for their governance and financial management. Some of these countries have undertaken systematic reviews of their EBFs that have abolished or merged many of them, and converted others into commercialized or privatized bodies. Progress along these lines has also been made in some middle-income countries (see Box 3).

V. A Strengthened Approach for Managing EBFs

The focus on extrabudgetary funds is warranted on the grounds of their substantial impact on fiscal policy and governance. The size of EBFs in many countries is significant and, by definition, encompasses transactions that are excluded from the legislative budgets and the budgets of local authorities.

The IMF has traditionally been critical of EBFs, in particular with respect to their impact on the soundness of fiscal policy analysis and control, fiscal discipline, flexibility and transparency. Though there is a sound economic and political economy rationale for establishing EBFs in some cases (social security funds in the first instance), and examples of successful and well-managed EBFs, the traditional argument remains valid in certain circumstances. In such circumstances, experience suggests that the rationale for EBFs can be better achieved by inte-

Box 3. Reforming EBFs in Bulgaria

Legal framework

The 1996 Budget System Law introduced the concept of a consolidated budget and provided a broader legal framework for extrabudgetary activities. The consolidated budget includes the budget and the EBFs.

Closure of EBFs

In 1997-99 all extrabudgetary accounts of budgetary organizations (over 1,200) were closed and the number of EBFs (established to finance national programs) was reduced from over 70 to about 20.

Budget and treasury coverage

EBFs are included in the annual budget presentation to parliament. They are part of the treasury single account and are required to meet the budget requirements for accounting, internal control, internal and external audit and reporting.

Revenue collection

The collection of social security and health insurance contributions has been integrated within the tax collection system under a unified revenue agency.

Management of EBFs

EBFs have substantial managerial autonomy. There are separate laws for the biggest EBFs (the Social Security Fund and the Health Insurance Fund). However, their regulatory framework as well as their business planning and operations should fully comply with the broader legal framework for extrabudgetary activities defined in the Budget System Law.

Fiscal consolidation

The problems with EBFs were addressed in the context of a broader fiscal consolidation reform. For 10 years, since 1998, the consolidated budget has been kept broadly balanced.

grating them into the budget process, and that the establishment of EBFs should continue to be regarded as a second-best approach. Where EBFs continue to exist, governments should be encouraged to apply the criteria for evaluating EBFs described in this note and to strengthen their governance and financial management arrangements.

Frequently, EBFs are established for dubious political reasons that are contrary to well-established principles of good governance and sound budgeting. In addition, however, this note has argued that EBFs exist because of serious failures in the national budget system that provide a strong incentive to bypass it. The implication is that the approach to addressing EBFs should incorporate both an emphasis on their macrofiscal consequences, and seeking to legislate against EBFs—which may still be an appropriate policy response in many circumstances—and a focus on developing a program of measures that should be taken, in the medium to long term, to address the underlying budgetary failures. Without addressing these structural issues, it is unlikely that attempts to abolish existing EBFs, or suppress the creation of new funds, will be fully successful.

A strengthened policy approach toward managing EBFs should include the following elements:

- The data on EBFs should be consolidated with the budget figures for the purposes of fiscal analyses and the presentation of information in fiscal reports. To this end, a comprehensive list of EBFs should be prepared and classified in line with the concept of general government set out in the *GFSM 2001* framework. This requirement should apply even to EBFs that are independently managed under separate legislative authority. The lack of coverage of the EBFs in fiscal frameworks can seriously undermine transparency and the soundness of macrofiscal analyses and advice. Advice for fiscal surveillance should also stress the need to identify and address the political economy factors and budgetary failures that lead to the creation of many EBFs.
- With respect to public financial management and the provision of related technical assistance, minimum requirements need to be met. Information on EBFs should be included in the budget documentation; and common requirements should be established for the classification of expenditure and revenue, accounting, internal control, and internal and external audit and reporting, using either the budget system itself or comparable parallel procedures. The authorities should be encouraged to introduce the concept of a consolidated budget through the budget legislation and to ensure adequate coverage of the consolidated budget through the public financial management system. They should also be encouraged to consider using the typology outlined in Section II.C as a framework for collecting data on the main characteristics of their EBFs and reporting this information with the budget documents.
- The approach to EBFs should distinguish between the need, ***first,*** for the central authorities to exercise tight control of the EBFs' budget preparation and execution, and for the financial reporting of EBFs to be timely, transparent and subject to rigorous procedures of oversight and auditing; and ***second,*** for the EBFs to be given authority to establish their own internal governance arrangements, as appropriate, and manage their business planning and operations in accordance with decisions taken by their senior managers, subject to being held accountable for their organizational performance and results.
- In addition, strong gate-keeping mechanisms, political as well as technical should be established to reduce the probability that unjustified EBFs will slip under the radar and eventually damage the integrity of the budgeting system. For example, governments should be encouraged to develop and promulgate an agreed policy position on the minimum requirements for EBFs based upon the criteria discussed in Section IV; and to formulate a legal framework for EBFs that encompasses essential principles of sound governance and financial management. Such a framework should cover both EBFs as legal and economic entities, and EBFs as transactions, a wider definition, as noted in Section II. Governments should also be encouraged to carry out a systematic review of their EBFs with a view to reducing the number of funds to the minimum necessary to achieve essential policy objectives.

- Finally, greater emphasis should be given to addressing the specific areas of budgetary failure noted above. These include issues that are already covered in many programs and technical assistance work (e.g., the development of medium-term expenditure frameworks, improving the quality of fiscal data, and strengthening financial management information systems). However, there are other areas that are equally important but less frequently addressed: for example, measures to promote the independence of external audit and strengthen the role of the legislature in the budget process and to decentralize the budget process to improve accountability. In short, there should be a much stronger emphasis on the governance aspects of reform in addition to fiscal reporting, budget classification, financial control, and other "technical" aspects.

Policy advice provided by the IMF, the World Bank, and others also needs to clearly distinguish between EBFs with a strong economic and governance rationale and those that are created to reduce transparency, bypass public scrutiny and hamper fiscal discipline. While the agency model—sometimes on-budget, other times off-budget—has been developed successfully in some OECD countries to encourage a better allocation of public resources, this is not recommended practice for developing and transition countries that do not have sufficiently strong governance and financial management systems to sustain such an approach. Issues relating to EBFs should always be addressed in the context of broader budget and governance reforms, and how these contribute to an overall sound fiscal policy.

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