The Micro Basis of Budget System Reform: The Case of Transitional Economies

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Abstract

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In reviewing the means to strengthen public expenditure management (PEM) systems, there has been increased emphasis on the micro basis of broader budget system reforms, especially reforms of the internal financial management systems in government agencies. Specifically in transition economies, there has been increasing recognition that OECD-type budget systems need to be broadly based on a firm platform of financial management in government institutions. At the same time, many transitional countries have generally acknowledged that this aspect of their PEM systems is problematic and needs to be rectified; hence, international agencies have been actively promoting reforms in these areas. In particular, three areas have been emphasized: human resource management, procurement, and internal audit. This paper explores the problems faced by transitional economies in each of these areas and reviews the generally recommended solutions to these problems.

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INTRODUCTION

In the initial stages of the transition process, reforms in public expenditure management (PEM) have largely focused on what may be termed the “macro” aspects of PEM—namely, putting in place new systems for budget preparation (e.g., delinking this function from the central planning process) and for budget execution (e.g., taking this function away from the central bank and setting up treasury systems in the Ministry of Finance (MOF). The broad thrust of this macro approach, that has been described elsewhere, tended to emphasize reforms within the central agencies of the government. Often, however, it has not been adequately realized that the viability of these new systems depended on supporting changes at the micro level. That is, the line ministries and other agencies of government were required to adopt these new procedures and consequently had to modify their internal management procedures to successfully operate in the newly reformed budget systems.

This paper is intended to help redress this imbalance in three main ways. First, by reviewing the nature of internal control systems, it stresses their importance not only for an effective system of PEM but also more widely for ensuring good governance. Second, by emphasizing the need to create a suitable framework at the macro level to facilitate and anchor reforms at the micro level, it emphasizes the need to balance reform efforts between the central and the subordinate institutional levels. Third, by examining in more depth the required micro reforms in three main areas—human resource (HR) management, procurement, and internal audit (IA)—the paper tries to convey a better appreciation of the extent of the challenge faced by transition economies.

I. THE IMPORTANCE OF INTERNAL CONTROL SYSTEMS FOR PEM

Internal management control systems describe a range of management tools aimed at different broad objectives: first and foremost, to ensure compliance with laws and regulations; second, to ensure the reliability of financial data and reports; and, third, to facilitate the efficiency and effectiveness of government operations. In this way, a sound internal control framework is designed to assure the public that these operations attain some basic fiduciary standards: in guarding against the misuse, and inefficient use, of financial and HRs; safeguarding assets; achieving budgetary objectives as set out in government policies and spending plans; countering fraud and error; and maintaining satisfactory accounting records to enable the organization to produce timely and reliable financial and management reports. As such, internal controls can be regarded as one of the foundations of good

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2 See, for example, J. Diamond, 2002; also B. Potter and J. Diamond, 2000.

3 See Managing Public Expenditure, Richard Allan and Daniel Tommasi, OECD, 2001, Chapter 10, which defines internal control “as the organization, policies and procedures used to help ensure that government programs achieve their intended results; that the resources used to deliver these programs are consistent with the stated aims and objectives of the organizations concerned; that programs are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported and used for decision-making.” p. 260.
governance in a country, the first line of defense against improprieties, and also providing the public with "reasonable assurance"⁴ that if they do occur they will be made transparent and appropriately addressed.⁵

Part of the heritage of the previous central planning system was weak internal management systems. Since detailed spending priorities were set at the central level, rather than by the agencies, the line agencies had little incentive to develop their management systems in order to judge the efficiency with which inputs generated outputs, or delivered needed services. Rather, allocations were driven by rules—norms—at a detailed budget line level. Good agency management was directed at preserving or increasing historical levels of funding in each budget line, rather than making these funds more productive in terms of final outputs. Managers had no incentive to spend their funds better. Indeed, being more efficient in meeting their norms would most likely result in their future funding being decreased. In this environment there was little incentive to develop internal management accounting, reporting and controls. However, in the transition process, this set of incentives changed. Faced with increasing resource constraints, and with a dismantling of the detailed planning system controls, there was increasing pressure to strengthen internal line agency management systems.

The range of management competencies and procedures required for good PEM at the agency level is quite wide, for example:

- to plan budgets, to set their priorities, to reformulate them in the required detail for management control purposes;
- to put in place a financial management system which enables appropriate categories of costs to be clearly identified, accounted for, and reported on;
- to establish internal procurement procedures to ensure that purchasing is directed to the most economical source, meeting acceptable standards of quality and timeliness;
- to put in place an accounting system to allow correct recording, and to generate required management reports ensuring control of, and transparency in, the agency's operations;
- to develop specific management procedures for important items of spending, like capital assets and HRs;

⁴ This concept is important, since there can be no absolute guarantee against wrongdoing or honest error. Rather, a control system should be designed to reduce that risk to a "reasonable" level compatible with the cost of implementing the control system.

to strengthen the agency's internal control mechanisms to avoid any new financial freedom, brought about by the dismantling of central planning controls, resulting in less effective use of public funds. These controls—based on a strong IA function—should also be viewed as performing a watchdog role within agencies to ensure the effectiveness of the other internal management systems.

Obviously, the way that internal PEM is organized and effected varies considerably among countries, and ultimately reflects the country's predominating budget management philosophy. For transitional countries transforming their economies and basic institutions from a planning to a market-oriented model, the reform of these internal control systems has been stressed as one of the basic preconditions for the success of this transformation process. As a consequence, international agencies such as the European Union (EU), the World Bank, and the Organization for Economic Cooperation and Development (OECD) have been encouraging transition economy governments to play an active role in strengthening the basic management controls of government operating units. Three areas in particular have been highlighted: government procurement, HR management, and IA. These are reviewed in some depth below.

II. HUMAN RESOURCE MANAGEMENT

A. Situation Faced by Transitional Economies

The fiscal constraints encountered in the transition process have directed attention to ways of controlling personnel expenditures, where the size of the public service is typically a major concern. To do so, it is recognized that these economies must reform their civil services and restructure their budgetary process for controlling the payroll.

The basis of the wage bill is often unclear. While in most transition economies, the basic pay scales and seniority increments are defined by law and are openly available; other kinds of supplementary payments to employees are often provided at the discretion of the line ministry management with little transparency. Most transitional economies have nominal centralized payroll systems—where both the wage bill, numbers and salary growth are set centrally—with strong decentralized elements, in which agencies or ministries enjoy discretion in managing their staff and adjusting pay.

To illustrate, in Russia and many of the former Soviet Union republics, while there is central determination of pay grades, with administrative levels "apparata" determined by the President and lower levels determined by cabinet decision, line ministries and spending units typically have had in the past much latitude. Indeed, there has been evidence in some republics of "ghost workers," staff paid for more than one position, and topping up of wages from off-budget sources. HR record keeping tends to be highly decentralized, with each ministry containing many groups of spending units for which a payroll is prepared. Personnel records are often kept in hard copy, often at the lower spending unit level, and with only certain information related to pay and pay entitlements kept in machine-readable form. The actual payroll processing tends to lack standardization, with no standardized worker ID
number. While automated to allow time sheet information to be converted into the pay entitlement, typically the software is not standardized, and, because of the lack of confidence in the banking system, cash payment rather than direct deposit is popular.

**B. Institutional Arrangements for Government Human Resource Management**

It will be noted that the term HR management is deliberately employed in this paper to indicate that strengthening PEM in this area implies more than better control over the payroll—the final stage of the process. It is important to stress that both at the central and agency levels there are two important aspects of HR management: personnel management and payroll management. The first concerns the maintenance of personnel management information—number of positions at various levels, the grades within those levels—and the tracking of movements between grades from recruitment to eventual retirement, taking into account leave taken, or vacancies, at each stage. The second concerns the determination of the wage bill, or personnel costs, by translating personnel management information into the remuneration profile and salary structure to calculate required payments each month. At both levels, there is often great difficulty encountered in bringing precision to this process, especially without adequate computer-maintained databases and the continued use of manual methods.

Although the need for a firm platform of financial management controls at the agency level before launching more ambitious PEM reforms may be appreciated, at the same time to be truly effective agency financial management must be set in a viable macro-control framework. Accordingly, when strengthening HR management in the government sector it is necessary to tackle the problem both at the macro and agency level.

**Macro framework for government HR management**

Abstracting from policy considerations, even in nontransitional countries there are often basic institutional problems faced by personnel reforms in the government sector. One typical problem is that HR management is organized in a fragmented way.

Usually control over the government personnel in nontransitional countries is exercised by, or at least coordinated, by some central personnel management office, such as civil service commissions, public service boards, or establishment boards.\(^7\) In some transitional economies, such arrangements may not yet be in place, in which case the Ministry of Labor tends to assume this role. Control over the payroll is usually exercised by the MOF, as an integral part of government fiscal policy. Usually there is a range of measures—the

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6 In some republics the Pension Fund Number, used to track individual contributions to the Pension Fund or the tax service TIN, is employed.

7 Covering such areas as coordination of staffing; securing parity in work classifications; training; drafting, updating, and mentoring of the implementation of civil service laws and regulations. See Sarraf, 1995.
organization/reorganization of budgetary institutions, creation/reduction in existing posts, determination of pay scales, allowances and bonuses—whose determination is shared by both institutions.

Since personnel costs are often the single largest cost of government, they receive much attention. In OECD countries it is not uncommon to find different central institutions assigned different aspects of HR management. For example, there is likely to be one institution that administers the civil service cadres, concerned principally with civil service policies, determining the overall the level of service positions, and often setting the individual staffing levels for each line ministry and government agency. Sometimes this institution is responsible for determining the civil service salary structure or salary levels. However, since wage increases in government often set the standard for the wage structure in the economy, sometimes this is set by an institution that has a wider remit for the whole public sector, or even the economy, as a whole. Often there also exists a separate body responsible for recruitment and transfers of staff and disciplinary action against government officers.

Then there are central agencies in the MOF, which are less concerned with the personnel administration aspects and more with the budgetary implications of payroll management. Not surprisingly, the central Budget Office is concerned with budget estimates of personnel expenditures, which typically is the single largest item of government current spending—this will involve it in scrutinizing personnel cost estimates of spending ministries, in the issuing of spending authorizations with regard to personnel costs, and in monitoring this spending throughout the year. Also typically, a Treasury Department is responsible for executing personnel payments, determining the procedures for payment of salaries by issuing checks in the name of respective commercial banks to credit the bank accounts of employees. Along with this goes an accounting, reporting and monitoring function.

Along with these centralized institutions is the crucial work of the line ministries and other government agencies that have the authority to recruit certain categories of staff (e.g., junior levels, temporary workers, specialists), within the approved number of personnel places (or “establishments”). They are required to report on actual recruitment, changes in scales, retirements and transfers, as well as prepare detailed payroll requests for the central agencies to execute.

**Importance of HR management at agency level**

In most countries payroll management is heavily decentralized, often more decentralized than other payment transactions. An important characteristic of payroll management is that salary payments require cumbersome calculations and operations prior to establishing the correct
amounts due for payment, and hence prior to actual payment processing. Similarly, for personnel administration it is generally recognized as unrealistic to have a central personnel management office to design or approve an organizational structure and create posts for a given ministry, because it cannot have the knowledge and mandate for coordinating policies and operations in the sector in which the ministry is involved.

At the same time, however, it should also be recognized that the decentralized approach to HR has little working value if the designer has no knowledge of the government’s macroeconomic and fiscal policies. There is an obvious need for a coordinated approach. This is more pressing in the most decentralized model where government agencies may also execute the payment vouchers against their own government bank accounts, and make accounting and expenditure reports to the center. As an important part of the control framework, one can expect the central agencies, and most usually the Treasury Department, to prescribe the procedures and regulations for payroll management at the agency level.

C. Approach to Strengthening Government HR Management

A two-pronged approach is typically recommended: strengthening the macro-framework for HR management and improving HR management at the agency level.

Strengthening HR management in centralized agencies

This typically involves the following approaches:

*Increasing institutional coordination*

Only after a careful definition of the roles and responsibilities of the various agencies involved in personnel management, can a coordination mechanism be established. In bringing about a greater degree of institutional cohesiveness care should be taken to avoid initiating decisions on staffing which will have financial implications on others, while at the same time ensuring there is some agency charged with enforcing regulations and applying effective sanctions.

*Strengthening the role of the MOF*

In designing coordination arrangements it is prudent to strengthen the role of the MOF. This can be achieved in a number of ways. First, this usually involves insisting on the primacy of the MOF in decisions that involve any commitment to spend. Thus no new post should be created without the prior approval of the MOF, and the need for any vacant position not filled for more than a year should be reviewed. Second, manpower planning should be separated

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9 See F. Sarraf, 1995, p.3.
from budgetary commitment. Final authority for the approval of the establishment strength, and hence the manpower budget, should rest with the MOF. Third, the role of planners as well as that of supervisory institutions should be advisory in nature—so that the MOF would need to be consulted for any recommendations that have financial implications. Fourth, the role of the MOF as a financial watchdog usually needs strengthening. The MOF must keep the final accounts of the wage bill, and carry out checks to ensure that the wage bills of agencies conform to approved positions and actual staffing levels. Care should be exercised to ensure all payroll payments follow financial regulations, especially with regard to vacant positions and staff on leave.

At the same time, this approach should not imply that all managerial control can be focused in the MOF—special functions such as HR aspects of staffing, training, pay scales and structure, job classifications and grading, the drafting and revising civil service laws, etc. are sufficiently specialized functions to belong to a different central agency. Rather the central areas of the MOF control should focus on: the approval of manpower levels in line ministries; the determination of short- and long-term financial implications of staff reduction and retrenchment policies; and, the determination of the payroll and pay structure for civil service as a whole.\(^\text{10}\)

**Creating a reliable database of government personnel**

Many transition economies experienced important governance problems with the collapse of a centralized planning and political system. Hence, there is usually a need to first establish a baseline for the payroll. This is required to clean out past abuses: e.g., overstaffing and irregularities in recruitment, irregular payments to ghost workers, additional allowances, reallocations to cover overheads, etc. A central audit should be performed to check and verify the master cards of all employees; perhaps even for some ministries a physical head count may be required.

After this initial screening exercise, a master database should be created. For these personnel data should be maintained at two levels. First, detailed personnel records should be kept at the line ministries/agencies. Second, government-wide records of positions, salaries, allowances, and other relevant personnel data should be held at a central level—the latter is the master database. This will contain such data as: approved number of positions at each level in all the agencies; name of the incumbent of the position; current grade and salary; etc. This database should be updated, at least quarterly and preferably monthly, based on information received from agencies. In this way it can support government cash management requirements.

\(^{10}\) Ibid., p.6.
Strengthening HR management in line agencies

This typically involves the following measures:

**Improving maintenance of personnel records at the agency level**

The usefulness of maintaining a master database will be dependent on the quality of the input from the agencies. This typically involves considerably improving their basic record keeping on personnel movements and pay, and in developing a standardized reporting system at least on a quarterly basis, and preferably monthly, so that these changes will be fed into the master database. To enforce agency record keeping, even if there are no changes in personnel, agencies should be required to certify that this is the case. The codes and classifications used on the master database should be administered centrally. A useful centrally imposed requirement is the issuing of employee identification numbers that are unique throughout the government; so that wherever an employee is transferred the same number follows him until retirement.

**Strengthening controls over payroll determination**

An adequate internal control system should be in place in the line agencies to ensure that the monthly payroll reflects accurately the actual staff working in each agency. The line ministries should prepare the monthly payroll with reference to their subset of the master database. They will need to supplement this with ongoing data on vacancies, leave, marital status, retirements, promotions, etc. This data should be subject to internal audit before payment is executed.\(^{11}\) There should also be procedures for crosschecking and reconciliation between the data at the central level and the data held at the agency level.

**Introducing a standardized computerized HR management system**

An important reform that will facilitate all the above-mentioned improvements is the development of a standardized computerized system for personnel and payroll management, along with a complementary information system.

Management information is a critical factor for developing policies and defining strategies. Typically, the existing information flows for HR management even if automated, could be considerably improved by greater standardization in software applications. This is also necessary for enforcing regulations in this area. For example, a budget institution may formally be required to be reported to a central agency, but without standardization such reporting generally will be difficult to consolidate, and consequently not be timely, complete, or accurate. Without enhanced computerization, auditing is time consuming, and the difficulty of enforcing the provision of adequate documentation means that there are weak

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\(^{11}\) See discussion of internal audit below.
audit trails. With a manual process the validation of data received from departments makes heavy demands on personnel resources, and the risk of inaccuracies and time lags in information flows are obvious. As a result, manual systems based on central compilation in large organizations involve substantial risks of inaccuracies due to misconduct or time lags.

The ideal solution will be the development of a payroll module as part of an integrated government financial management information system. However, to be effective, enhanced computerization usually requires an initial investment in cleaning up the existing data. Software applications for personnel administration and payroll only lead to improvements if the data is correctly entered. As long as payment processing and accounting are manual, the information on personnel expenditures will not necessarily be more accurate. The speed at which such computerization can be implemented is dependent on a number of factors, not the least of which is the existence of the necessary skills, as well as training in standard software packages.

III. GOVERNMENT PROCUREMENT

A. Situation Faced in Transitional Economies

Public procurement of goods and services often represents a significant share of a country’s GDP, and hence the procurement system is an important component of a country’s PEM system. At an early stage, transitional economies recognized when their centrally planned economies were liberalized that as an integral component of such market-related reforms, public procurement regulations would need to be changed. The reform of public procurement legislation, the introduction of institutional structures and detailed administrative procedures has been a high priority task for transitional economies in the past decade. While much progress has been made in establishing a suitable legal framework, and a central authority to administer it, the task of reforming procurement within budget institutions remains a challenge, which is unlikely to be resolved easily in the short run.

The case of Russia is illustrative. Russia, like many other former Soviet Union countries, has enacted a series of public procurement legislative instruments, both at federal and subfederal levels, which has fostered more competitive procurement. However, a large component of procurement still is conducted under restrictive methods, and many public tenders are subject to excessive restrictions. Unfortunately, the legislative framework is complex and

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12 For estimates from Government Procurement Agreement (GPA) members, see Annual Reports to the Government Procurement Committee, WTO, Geneva, various years.

13 It has been estimated that in 1999, 53 percent of public expenditure on the purchase of goods, works, and services were carried out through open tender, the most competitive procurement method available under existing legislation (see World Bank, 2000).
uncoordinated, with serious gaps.¹⁴ Not only does this make it difficult for government officials to apply the legislation, but also it is recognized that they lack the administrative capacity to do so. Thus, like many transitional economies, Russia faces problems of streamlining and enforcing the application of procurement legislation, of strengthening the institutional arrangements to oversee and enforce this legal framework, and, at the same time, of training large numbers of public officials in procurement.

B. Macro Institutional Framework for Government Procurement

The framework for government procurement requires strengthening both the legal and institutional basis:

A firm legal base for procurement

There is common agreement that the procurement system must be founded on a firm legal basis. Most central and eastern European countries have already reformed their public procurement legislation—a process that has been influenced by the EU, and international institutions like the World Bank, and World Trade Organization (WTO).¹⁵ Most influential has been the UN Commission on International Trade Law (UNCITRAL), which prepared a model law on procurement in 1994 as a basis for countries planning to transform their procurement laws to comply with international standards.¹⁶ The UNCITRAL Model Law was prepared with the national government in mind, and an enactment guide is also available for legislators to assist in interpreting and applying it. Since 1994, many transitional economies have used the Model Law to redraft or amend their national procurement systems. These include Albania, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Russia, Slovakia, and Slovenia.¹⁷

For transitional economies contemplating entry into the EU, the associated customs union directives stipulate procurement requirements, and since the EU is a signatory of the WTO

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¹⁴ The most relevant is Presidential Decree No. 305, issued in 1997, which supported regulations closely patterned on the UNCITRAL Model Law. However, the subsequent procurement law enacted by the Duma in May 1999 fell short of the standards set by the Model Law. A discussion of the drawbacks in this law is contained in World Bank, 2000, pp.3ff.


Agreement on Government Procurement, this agreement must also be accommodated.\textsuperscript{18} The EU directives, however, only address contracts above a certain monetary threshold, which means smaller value procurements are expected to follow national regulations, and will only be subject to basic provisions in the Treaty of Rome that prohibit discretionary treatment from other member states. All international approaches (the Model Law, the WTO, EU and the World Bank) share some common principals: first, openness through active advertising and a preference for open tendering; second, equal treatment with neutral specifications and objective award criteria; and thirdly, transparency, with clearly defined rules applied in a predictable manner and subject to public inspection.

While the EC participated in the formulation of the Model Law, there are some differences in emphasis, and the countries that used the Model Law did not pay much attention to future compatibility with EC directives. For example, while the EU directives do not go far into organizational issues, they do imply central supervision, but follow the principle of "subsidiarity," with authority in implementation delegated to procuring agencies. In contrast, in many countries procurement legislation insists on major awards exposed to prior reviews by a higher authority. The EU coverage of procuring entities is wide and also extends the concept into the public enterprise sector (e.g., utilities). The Model Law envisages that a government in special cases can exclude participants from certain countries, but the latter could not be allowed under EU rules for Member States or GPA participants. The Model Law also opens up the possibility of a preference for domestic tenderers and methods of procurement specified in the Model Law deviate from those in EU directives, often substantially. However, unlike the Model Law, EU directives are binding. As a consequence countries with laws modeled on UNCITRAL's, and contemplating EU accession, need seriously to consider amending their existing legislation.\textsuperscript{19} The solution adopted by several countries is a "two-tier" approach: major contract regulations aligned with the EU directives and smaller contracts awarded according to other, perhaps simpler, procedures.\textsuperscript{20}

\textbf{A central unit supervising government-wide procurement}

There is also the need to establish a suitable administrative structure for implementing laws on procurement. The Model Law suggests that national procurement policy and implementation is administered by a single authority (e.g., within the MOF, the Ministry of Commerce, or a specialized Central Procurement Board). It envisages that this central unit


\textsuperscript{19} For the example of Poland, see P.N. Gorecki, "Development of the Polish Public Procurement System," SIGMA, Public Management Forum Vol.IV. No. 2, March/April 1998.

would be authorized to promulgate procurement regulations and carry out the provisions of the law, but otherwise the Model Law contains no specific institutional recommendations.

In countries where these functions are vested in a Central Procurement Board or Central Procurement Office, reporting directly to the government, it is also suggested that the MOF be included in the approval and empowering committees set up by such a Board or Office. In addition, both EC Directives and the WTO Agreement require the establishment of a review or remedy procedure for each member country. For this purpose a review body is recommended, which may be judicial in nature. EC Directives envisage specific powers be granted to the review body including the power to: institute corrective actions quickly; institute preventative measures; suspend a procedure for award of a contract; set aside decisions of the procuring entity; and award damages to persons harmed by infringements.

There are many different country interpretations of the role of the central office, which differ in the degree to which the office is seen to enter into the procurement process, rather than being a supervisory body. It may be useful to review its possible core functions, namely:

Supervising overall implementation of procurement law and associated regulations

This may, for example, include the issuance of procurement regulations, monitoring implementation of the procurement law and regulations, making recommendations for their improvements and issuing interpretations of those laws. In some cases, e.g., for high-value contracts, this central office might be empowered to review the procurement procedures to ensure they conform to the law before the contract is signed.

Rationalizing and standardizing procurement practices

This can be accomplished by several means:

Standardizing procedures

This may include, for example, co-coordinating procurement by procuring entities, and preparing standardized procurement documents, specifications and conditions of contract. It could also be responsible for training the procurement officers and other civil servants involved in operating the procurement system. In cases where procurement actions and decisions do not follow standardized procedures such exceptional procedures would be subject to prior approval by this authority. The advantage of the prior approval system is that it provides an added measure of uniformity in a national procurement system, particularly when it is implemented as an otherwise decentralized system. The central office should also be able to provide the service of collecting data in the procurement area, which can be useful feedback for policy purposes and can help improve the functioning of the system—this is also required for participation under international agreements.
Vetting bidders' qualifications

Generally, guidelines will stipulate that contracts should be awarded only to bidders who can demonstrate their financial, technical and production capability to undertake them. For work contracts, this is done by prequalification of the successful bidder. Normally, this is not done at the central level. However, it should be noted that the WTO Agreement emphasizes keeping the qualification process as open as possible and ensuring that companies from all countries are treated equally, and it should be the task of the Central Office to ensure this. The WTO Agreement requires each member country publish their lists of qualified companies if they maintain permanent lists.

Reviewing the contracting process to ensure clarity and consistency in requirements

Technical specifications must be clear and comprehensive, so as to describe the goods with sufficient accuracy and detail to foster competition. This is no simple task, and covers a variety of aspects: climatic factors affecting performance; compatibility with other equipment; tests, standards and techniques of assessing the equipment's conformity; special technical factors that must be taken into account in evaluating bids. At the same time unnecessary requirements should be avoided. If they are redundant, they detract from clarity, and if unnecessarily restrictive they reduce competition. It is up to the central agency to monitor the consistency of requirements, and also promote a policy that technical specification requirements are written to maximize the use of international standards and performance specifications.

Maintaining standards in the procurement process

Specifications must be monitored throughout to see they are not substantially changed after the bid opening, whether to accommodate a bidder’s interpretations or for other reasons. At times bidders request clarification on specifications, special conditions, etc., prior to closure of bids. In the case that the replies cause a deviation in the specified terms of the bid, the central agency should ensure that the procuring agency circulates this information to all prospective bidders. Ensuring that technical specifications, as far as possible, should be based on performance characteristics, with a minimum of design characteristics. Since each supplier normally has his own design for achieving specified performance characteristics, stipulation of design characteristics can limit competition. In drawing up technical specifications, a balance may have to be struck between the expected advantages of the most up-to-date model, and the risks of teething problems if that model has been fully tested in service. While this decision will typically be taken by the procuring agency, the central office may have to adjudicate on this balance. This is not easy for rapidly developing technologies, such as in computerization. Thus, while specifications are a technical issue, generally

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21 They can, of course, be changed within reasonable parameters so as not to undermine the basis upon which proposals are submitted.
requiring the expertise of the procuring agency, the role of the Central Office is to ensure that they are not restrictive or biased.

*Specifying policy on criteria for selection*

The central body should set a standardized methodology for selecting successful bids and check to see that criteria are not biased and the ratings are fair. For example, some countries utilize a simple point system—awarding marks to the lowest responsive bid and also for such features as after-sales service. However, this gets complicated for sophisticated contracts and has a discretionary element in defining the rules used for allocating points. A better system is to gauge the life-cycle cost of the bid: taking into account the capital cost of the equipment, its operating and maintenance costs over its useful life, associated training and personnel costs, and the residual or resale value of equipment, and then discounting these costs to reduce them to present values. Obviously, assessing life cycle costs in all but the simplest purchase is a highly technical exercise and one that will inevitably require some subjective judgment about future developments (estimated life of goods, inflation, uncertainty in project data). Failure to recognize the risks and potential opportunities over the life cycle early in the procurement process leaves the way open to incur significant additional real and opportunity costs in the future.

*Risk assessment from the standpoint of broader government policies*

The central agency should also take upon itself a role in providing strategic and marketplace considerations regarding government procurement. For example, this agency could provide guidance on such aspects as the risks of lack of conformity with delivery and the operational and financial effects of earlier or later availability. But also strategic concerns such as the risk and dependency of agencies as well as the influence on the market structure should be considered. Other more general concerns will be to safeguard essential sources of supply; the length of the supply chain and its vulnerability to disruption; and the effect of procurement on price, availability and competition for future requirements.\(^{22}\)

**C. Role of the Procuring Agency**

The process of procurement is often not sufficiently recognized as an important and often time-consuming PEM function in government agencies. Once the framework for procurement is established, individual executing agencies are heavily involved in the actual process of procurement: from the initial application, usually through their supervising Ministry, then preparation of bid documents, publishing the notice calling for bids; issuing

\(^{22}\) The presumption that the government’s objective is to minimize its costs of having work done may not always be true. It should be recognized that sometimes governments use their procurement policies to further particular social or political ends, e.g., the development of technology, the encouragement of small businesses, the directing work to high unemployment regions, etc. However, an evaluation of whether these social objectives are cost effective should always be made by weighing costs and benefits.
tendering forms; being present at the opening of tender bids, and all tender technical committee meetings, and generally assisting the work of the tender board. Once the tender board takes a decision, they are usually responsible for conveying the decision and following up with the successful tenderer, and then preparing the approved contract document. Thereafter, the agency will be responsible for the monitoring of the execution of the contract, and the investigation of any shortcomings, and the resolution of any following conflicts.

For the successful accomplishment of these tasks, transitional economies generally must face and resolve two important operational issues:

**Degree of centralization in the system**

It is usual to recommend a system of centralized oversight with decentralized responsibility for implementation. That is, a central procurement office sets policy and provides management with the tools to control the quality and consistency within a decentralized system. In some cases, this implies doing away with tight thresholds that require implementing organizations to seek approval from the central office for contracts above a value threshold before making a contract award. In other cases, only the higher-risk, higher-value procurements would be subject to central control. Otherwise control should be the responsibility of the implementing agency.

In initial stages of transition, where good governance is suspect, there may be danger in moving to fast to this model. First, there is the question of whether there is adequate administrative capacity to operate a decentralized system. Some of the skills required, e.g., computerization knowledge, may be hard to come by, certainly at a line agency level, and hence require a central pooling of specialists. This may argue for first developing a centralized corps that allows easier training, as well as the development and testing of procedures. Rather than slowing the reform process down this approach may actually move it along faster. Second, until internal controls are strengthened, and external audit is developed, there are obvious governance concerns in too speedily decentralizing procurement decisions.

It should be recognized that many countries, including transitional economies, have centralized procurement agencies for common use items and for specialized types of procurement. Too often these organizations are the subject of complaint from user organizations. The growing trend has been to use such centralized purchasing as a service at the discretion of the procuring agency and not make it mandatory. When this has been done it has had the effect of forcing the central purchasing organizations to improve their operating efficiency and provide better service. It also gives the user organization more authority and responsibility to implement their own procurements if they feel they can do a better job than the central purchasing organization.
Need to upgrade agency internal management of procurement

Procurement is not a task without skill: to obtain the best value for money, obtaining the "right products at the right time and at a satisfactory price" is a challenge in any environment. In transition economies it is even more demanding. Typically, government agencies are in great need of improving their internal management of purchasing, and at the same time are under pressure to do so from a number of sources:

Dealing increasingly with international markets and suppliers

For transitional economies, the exposure to international markets creates its own problems. While domestic suppliers may tolerate slow payment from the government, this practice will not be so well tolerated by international businesses. Contracts with international companies demand payment strictly in accordance with the contract terms and conditions. Often national procurement laws insist on tender securities. Slow release of bid securities and performance securities will discourage participation in government procurement, and again are unacceptable to international firms. Generally, it is recommended that bid securities and performance securities be limited—typically the extra costs in administering this requirement exceed its benefits. Certainly, any pressure that arises to use procurement process as a means of cash flow control in addition to normal agency cash limits set for cash management purposes should be resisted. Such considerations imply much closer control over the planning and implementation of procurement contracts.

Dealing with increased choices and a more uncertain market environment

The market system demands that procurement management be more flexible and sophisticated: e.g. using price adjustment clauses in situations of high inflation; the design of price adjustment clauses which index both labor and material costs against impartial indices, which reflect the impact of inflation; or using advance or progress payments. Similar problems arise with exchange rate variations. However, perhaps more serious problems arise as transitional governments come to grips with more advanced and uncertain technology. In procurement, choices cannot be avoided—between alternative characteristics of various products, say higher quality versus lower prices. Uncertainty greatly complicates procurement choices. In some cases the government knows what it wants, the products exist and are being traded in competitive markets with full availability of price and quality information. But when buying high technology equipment, the government might only have a vague knowledge of what it requires and the products will not exist, so the latter have to be developed specially for the buyer's vague requirements.

Also there may be wider ramifications, which were resolved in the central planning system at a higher level and by other means. For example, in the country there may be no other buyer (e.g., for defense equipment) and perhaps only one supplier, so the government has to bargain with a sole supplier about the appropriate type of contract for: a project which does not exist and whose specifications are not well defined. Similar issues are raised through locational monopolies in the utilities area. In cases where the government is the major or sole
buyer its purchasing decisions can have a major impact on technical progress in that line of production, the size of the industry, its structure and employment. These wider ramifications imply policy rather than procurement decisions, and should be directed to those bodies responsible for such policy decisions.

**Choosing contracts to meet specific situations**

Moving over from a system based on state orders to one based on contracts considerably complicates government purchasing. Contracts are central to trading activity and can take a variety of forms—varying between fixed price, cost-plus or some form of target cost incentive contract. Typically fixed price contracts are used where the work can be specified clearly and there are few uncertainties, so that these contracts can be determined by open or selective competition. Where work will extend over a number of years and involve substantial risks and uncertainty, contractors are likely to require some form of cost-reimbursement contract with the government bearing most if not all the risks. Unfortunately, cost-plus contracts in noncompetitive markets provide contractors with the financial framework, which encourages cost escalation, delays, “gold-plating” and the hoarding of skilled labor. A target cost contract is based on the target cost and a sharing ratio whereby the government and the contractor share the cost savings and losses. These are usually negotiated, with the contractor bargaining for the maximum possible target cost and for a favorable sharing ratio. All such arrangements require an entire new range of management skills that can only be developed over time.

**Administering contracts in a cost-effective way**

Apart from the choice of contract, governments face considerable demands in administering contracts. This is reflected in the transaction costs of acquiring information about products and suppliers, organizing competitions, bargaining with contractors and then writing, monitoring and enforcing contracts. Consideration of such administration costs can also affect the choice of contract. Because payment under incentive contracts and cost-plus contracts depends on the costs incurred by the contractor, some auditing of contractors’ claims may be required to ensure the claimed costs have in fact been incurred. Indeed under cost plus contracts it is common government practice to supervise the contractor’s work directly—in effect implying a 100 percent auditing. Even fixed price contracts require auditing, since payment may not vary with costs but it is necessary to check the contractor’s work is up to the required standard. Of course, auditing can be done at random where the purpose of auditing is not so much to detect illegal behavior as to deter this behavior. However, as discussed below, the auditing function is typically rather weak in transitional economies.

The above considerations illustrate the greater volume of work and the higher level of expertise that would be expected of procurement staff as the budget system is transformed to operate in a market environment. Given this need, there is a case for the establishment and development of agency purchasing units to carry out these new functions—recruiting or seconding from the private sector where necessary, and supported by a national training
program. Just as accounting emerged as a specialist area, requiring both internal and external training, so procurement should develop as a functional specialty providing a career path, possibly including membership of an appropriate professional body. The aim should be to have specialists involved in day-to-day activities, reporting to the agency’s manager. The purchasing units should view themselves as service operations, whose primary function is to support an agency’s operations and objectives. That is, their role would be to provide goods and services required by users in an economical, efficient and effective manner, rather than exercise control over operational decisions. In return agency purchasing units can only develop fully in this way if they are given the freedom to shop around and buy competitively——i.e. they are untied from centralized purchasing agencies.

IV. INTERNAL AUDIT

A. Situation Faced by Transitional Economies

Transitional economies in central and eastern European countries, especially those of the former Soviet Union, have little tradition of IA in the sense of internal to the budget institution. Rather, these countries inherited a system based on control by a department in the MOF. These operated as an investigative rather than a preventative institution, carrying out special investigations on alleged irregularities and fraud. Overlaid on this traditional audit function most FSU countries, like Russia, have instituted an external audit institution. Unfortunately, there has often been confusion in the separation of the roles of both functions. While lines of reporting have been different—the IA to the MOF and the external audit to the legislature—some overlapping in functions is evident. Normally, in transition countries, like the former Soviet Union republics, the main spending ministries also have financial controllers that perform a partial internal audit function——this tends to be weak, mainly investigative in nature, and generates few reports.

For example, in Russia there has been a move to refocus the work of the MOF central department (Control and Revision Department), which has been renamed the Department for State Financial Control and Audit. However, the approach retains the concept of a central inspectorate, and also the emphasis on control and investigation of irregularities. There are some concerns that there is an overlap in the role of the external auditor, the Accounts Chamber (AC), and the IA. The AC has been given extensive responsibilities not only in monitoring budget execution but also in providing an input in budget preparation——serving the needs of the legislative branch in this regard.

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23 In some republics, like Azerbaijan and Armenia, the traditional function of the central inspectorate continues. In others, reforms have already taken place: for example, Georgia has closed the inspectorate and moved the personnel to the tax office, as auditors; and in Tajikistan, it has also been closed and the personnel moved to a new external audit body.

B. Institutional Framework for IA

In moving their budget systems towards OECD standards, the role of IA will definitely require it to be better defined in transitional countries. Recently, there has been progress in reaching a consensus of what audit standards governments should meet. Both the International Organization of Supreme Audit Institutions (INTOSAI)\(^\text{25}\) as well as the Institute of Internal Auditors (IIA) have issued auditing standards to guide the auditing and accounting professions.\(^\text{26}\) While such standards do not have mandatory application, they are generally regarded as reflecting “best practices,” so that while it is expected that countries will develop their own public sector auditing standards, generally it is also expected that they will try to keep them consistent with the international standards.

These international standards adopt a broad view of the IA’s role, placing it more centrally as an important element of PEM, and move it beyond a narrow compliance or financial regularity viewpoint. The emphasis is on the IA as a management tool, as an integral part of management controls, as well as information and communications processes. From this perspective, the IA’s role is to review, appraise, and report to budget managers the soundness and adequacy of internal controls (e.g., safeguarding assets, ensuring reliable records, promoting operational efficiency, monitoring adherence to policies and directives).\(^\text{27}\) The IA function is thus seen performing as a watchdog to ensure the effectiveness of internal management controls.

Unfortunately, these international standards for many countries, including those in transition, would appear hard to attain. The standards stress four aspects of IA:

- **Independence** to make objective judgments. This implies that the auditor will have no direct management responsibility for what is being audited, he is to be free to choose any transaction/topic for audit, and is allowed access to all necessary information to come to an informed judgment. Unfortunately, in many countries, systemic governance problems often imply real difficulty in assuring the IA’s independence.

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\(^{27}\) The Institute of Internal Auditors defines internal audit as: “an independent, objective, assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve effectiveness of risk management, control, and governance processes,” IIA, June 1999.
• **Professional proficiency.** This assumes an appropriate audit methodology, technical competence, and sufficient level of resourcing for the IA function. In many countries it must be recognized that audit skills are in short supply, and professional proficiency can be very low, or the government’s pay scales cannot attract or maintain suitable staff. These factors often represent an important constraint on attempts to strengthen the IA.

• **Scope of the IA** is wide. The scope of the IA described in these international standards is based on the broader view of the IA as a tool of management, where the IA function closes the loop in the agency’s PEM management cycle in ensuring the efficient and effective use of resources. This in turn, assumes a mechanism under which audit reports are followed up and acted on. For many parts of the world, as in many transitional countries, the IA has often been, and continues to be, defined rather narrowly—focusing on financial compliance and regularity, rather than broader management issues. Moreover, governance problems and lack of professional competence also constrain the IA to this role and hinders its ability to generate timely and relevant reports.

• **The management of the IA function** is critical to its effectiveness. In many countries, management of the IA is often poor—poor work practices, lack of planning and personnel management, with little support from the external audit. Additionally, management is constrained by the institutional arrangements for IA, which often compromises the role of the IA as an aid to internal management.

It should be recognized that even in OECD countries the institutional framework for IA varies greatly, for example, from centralized to decentralized approaches. In the centralized model, the MOF not only plays a key role in budgeting and allocating funds to line ministries, but also directly intervenes in ex-ante controls, placing its own staff in the line ministries. In this environment the IA is focused on a specific organization performing certain control functions, traditionally a centralized ex-ante financial control organization, an inspectorate general, or a treasury external audit service. In the more decentralized approach, each line ministry takes full responsibility for spending its own budget and for ensuring appropriate checks and safeguards on the way this is spent. In this environment, the IA is focused on the overall system of organization, controls, rules, procedures, and regulations set up to ensure the most economic, efficient and effective use of resources. To do this, the IA control system includes the range of ex-ante controls, systems, performance, and IT audits. However, other models must be recognized, some of which appear to mix internal and external audit functions. For example, in Germany the IA is not part of a government agency’s control system, but can be viewed as a component of external audit.

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28 See A. Gray, et al., 1993. The external audit institution does this for the government as a whole.

29 While the IA cadre operates within agencies, they are subject to technical and professional guidance, as well as supervision, by the German supreme audit institution, the Federal Court of Aud. They report only to the supreme audit institution, and perform a “pre-audit” role rather than a traditional IA role. See discussion in
However, whichever their IA approach, there are some general principles, which seem common among OECD countries. First, the IA is viewed as a central component of internal financial controls aimed at protecting the government's financial interests. The important concept is internality of this executive function distinguishing it from external audit. Second, IA activities, although including traditional compliance and regularity operations, can be defined quite widely to include substantive tests, systems, performance and IT audits. Third, to function effectively, the IA must be functionally separated from the day-to-day management of an organization, (otherwise the accountability of designated managers will be diluted), but at the same time have an input to top management to ensure its findings and recommendations result in corrective action. Fourth, internationally recognized auditing standards should be applied.

In developing the IA, the most important step faced by transitional economies is undoubtedly deciding on the role of the IA in a country’s budget management. Establishing an overall framework to develop IA in a country involves two basic design questions:

- control versus a management orientation—a question of objectives to be pursued by the IA;
- degree of centralization in the organization of IA—a question of the organization of the IA function;

Once this framework is established, there come further questions of how this will be implemented at the agency level:

- relationship with external audit—a question of responsibilities and coordination; and
- restructuring work practices in agencies—a question of operational effectiveness.

**Deciding objectives of IA**

As indicated, from existing international practices, there are a variety of interpretations of the role of the IA. At one extreme, there is the centralized view of IA as a support function to the

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30 Larsson and Madsen, op.cit. p. 5. "IA is the total sphere of activities of ex post verification by an organization (located within the organization to be audited but independent of the management functions of that organization) of whether management and control systems comply with budget specifications, objectives, rules and standards and, more generally, to the principles of sound financial management."

MOF, assisting the MOF in monitoring ministry and department compliance with MOF financial regulations, instructions, and accounting procedures. The emphasis is on compliance and control. Alternatively, IA can be viewed as assisting budget managers in the effective discharge of their responsibilities by maintaining a feedback on their use of public resources through the submission of reports and, when justified, offering appropriate recommendations for corrective action. The emphasis is on efficiency and effectiveness in the use of resources and the delivery of services. Between this decentralized approach and the centralized approach, there exist many variants, among them the existence of a central inspectorate to set standards and to assist, when required, decentralized IA units in the line ministries with delegated responsibilities.

The overall design of the IA function should be geared to the specific priorities of a country. For those countries with governance problems, the foremost objective should be to ensure compliance with the financial laws and regulations. For those transitional economies 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. It is doubtful if many transitional economies can be viewed as having reached this stage.

**Deciding on the degree of centralization**

A fundamental design issue to be faced is the degree of centralization in the organization of the IA function. The centralized approach has often been viewed as better from a capacity-building viewpoint, where it has been argued that this approach:

- **Allows easier maintenance and better development of the proficiency of internal auditors:** In a situation of scarce skilled manpower, it is often argued that a decentralized approach often implies the diversion of IA staff to other duties that will reduce the proficiency of the staff. However, if the MOF develops a special cadre it will be able to concentrate scarce auditing resources and so maintain proficiency, ensure their specialization, and develop centralized standards and training programs for the cadre.

- **Maintains more independence:** The audit should be operated with adequate independence. The centralized option is better in this regard, it is argued, since the IA is managed by the MOF outside the direct control of line ministry managers. However, it is recognized that the necessity of appropriate independence is in direct conflict with the necessity of the MOF's close cooperation with other departments for budget management.

However, some disadvantages of centralization are also evident, namely that it:

- **Weakens accountability of the line ministry management:** It could be argued that the prime responsibility for internal control should be the responsibility of, and be
“owned” by, the line ministry management. However, the centralized option divides
the responsibility between the line ministry management and the MOF, obscuring
the ownership (or accountability) of this control mechanism. The line ministry
management may be only too happy to consider the responsibility for internal control
as the MOF’s.

- **Is of limited effectiveness because of the weak transparency:** Under the
circumstances found in many countries, the flow of information to external officials
(internal auditors from the MOF), is typically limited and untimely, constraining the
effectiveness of the IA.

- **Fails to foster close cooperation with other departments:** Close cooperation with
other departments is essential for efficient IAs. However, the centralized approach
does not promote such cooperation—the internal auditor is viewed as the “spy” of the
MOF, rather than a member of the line ministry management team.

In weighing these two options—the centralized or decentralized design for the IA—there are
considerations that suggest the answer will be country specific. First, the danger in an
entirely centralized approach, that the MOF will assume responsibility for the rectitude of
financial management in budget institutions, undermining the basic accountability of budget
managers, is very real for many countries. Secondly, if the risk of political interference with
routine budget management were high, so that the budget manager’s accountability is
undermined from above, a centralized system would be more justified. In some areas of the
world, a weak supreme external audit body implies that the risk of political interference must
be regarded as high. Thirdly, where the administrative capacity to perform IA functions is
low, in regard to the recruitment and maintenance of competent staff, a centralized system
controlled by the MOF would also be recommended. Given the time it will take to establish
a professional corps of internal auditors in many areas of the world, including transitional
economies, this is a most relevant consideration.

Taking due account of the above considerations, often a centralized approach, at least
initially, is recommended for transition economies as the most prudent approach, although
this runs counter to the basic decentralized institutional model underlying many OECD IA
systems. As argued previously, the latter are based on a budget management model that may
not be the most relevant to transitional countries. Faced with recurring economic problems,
and at the present stage of their institutional development, a more relevant budget

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32 Although at the same time operating at arms length to secure some independence from day-to-day operations.

33 It can be noted that the European Commission recently decentralized the responsibility for spending to avoid
weakening accountabilities of Commission managers. That is, “the explicit prior approval of a separate financial
control service has been a major factor in relieving Commission managers of a sense of personal responsibility
for the operations they authorize... while doing little or nothing to prevent serious irregularities....” See OECD,
management model should stress compliance and centralized controls to ensure stabilization objectives, and have an IA system to support them.

C. Strengthening IA at the Agency Level

Ensure independence of IA

An important objective in restructuring the IA function is to give some assurance of its independence from day-to-day management and hence greater objectivity in its evaluations. Obviously, the degree of independence of IA is not the same as for external audit, which reports to parliament. Rather, the IIA defines IA independence in the following terms: “Internal auditors are independent when they can carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. It is achieved through organizational status and objectivity.”34

Ideally, the internal auditor should be responsible to the minister or the chief executive of the ministry or agency. In a decentralized model, the internal auditor will report directly to this top official. In the centralized approach, having the centralized office reporting directly to the Minister of Finance ensures the independence of the IA.35 The internal auditor is responsible to the head of the ministry/agency; he is part of that agency’s staff. While part of the chief executive’s management team, care must be taken not to infringe the cardinal rule of audit: an auditor should not audit himself.

Typically, this is handled by several institutional mechanisms:

A clear and agreed definition of the internal auditors’ tasks

This a way of clarifying the place of the IA function in the work of the budget institution, dispelling ambiguities and avoiding disputes when the internal auditor carries out these tasks.

Establishment of line ministry audit committees

These should be formed from the top management of the institution and technical experts in the accounting and budget fields. The aim is to act as a steering committee for the work of the IA, identifying problems as well as the corrective or preventative action. Not only does this act to strengthen the role of IA within the agency in enforcing financial discipline, but also gives the IA some distance between the agency’s regular operations and IA evaluations.

34 IIA, 1999, p.11.

35 Of course, it is necessary for the MOF to maintain its own IA, and be subject to the close scrutiny of the external audit institution.
Central audit committee in MOF

Similarly, to enforce this distance from day-to-day management, and offer some external support, it is also recommended that a central audit committee in the MOF review the findings of the IA units and pursue remedial actions. Another possible mechanism is to have an independent external review of IA practices every two or three years by outside professionals, countering any tendency for agency managers to interfere with the IA.

Clear demarcation of responsibilities in relation to external audit

In some ways, this can be addressed by a clear and well-documented definition of the duties of internal auditors. At the same time, the relationship between the two functions should be recognized as symbiotic—it is important for the IA that there is a strong external audit, and vice versa. The external audit should use the work of the IA, and the IA should be guided by the findings of the external audit.

Restructuring work practices

A strategic decision to be taken in many transitional countries is where best to deploy scarce audit skills. There are, however, ways to economize on the use of these scarce IA resources:

Prioritize to extend scope of IA

Improved work practices, say by moving away from extensive pre-audit of vouchers to a sampling approach, can often offer significant savings, as can improved management of the audit function through focusing on priority areas and key weaknesses identified. One typical area, which may benefit from IA review, is the evaluation of internal controls. An important function of the IA should be to examine and evaluate the adequacy and effectiveness of internal controls in the existing systems, as well as the new systems before these are introduced. This clearly implies that the entire system of internal controls in the government has to be reviewed for each ministry/department/agency, as well as function-by-function. This area needs to be emphasized because, if there are strong internal controls, the system will automatically have its own checks and balances and minimize the possibility of errors, irregularities, and fraudulent manipulations.

Creation of special teams

In examining the IA of transitional economies, it is not unusual to discover that there are many functions, which are either not being performed, or the coverage is superficial because of inadequate staff, lack of specialized skills, etc. Often the most productive use of limited IA staff is in special central teams earmarked for conducting special audits in government agencies with the assistance of IA staff already stationed there.
Better formulation of work plans

Existing operational standards for IA require that the Internal Auditor adequately plan, control, and record his work. Such planning should be done not only for individual audit assignments, but also for varying time periods such as a quarter, a year, and even longer periods.

While such approaches can make IA more effective, the conclusion that cannot be avoided is that IA is such a fundamental element of PEM that its proper resourcing should not be neglected.

V. CONCLUDING REMARKS

A central message emerging from this review is that the broad scope of budget system reforms required at the micro level is a warning not to underestimate the magnitude of the task or the time that may be required to implement them. It must be remembered that these new management procedures need to be effected throughout the government sector. Unlike macro reforms which have been focused on a few central agencies, the micro reforms affect potentially a large number of institutions, and hence a much larger number of people. Accordingly, the scale of the problem raises important issues of administrative capacity—for example, developing internal auditing when there is a shortage of accountants generally in the economy, and especially in the government sector. Also the lack of specialized computerization skills acts as another significant constraint in developing modern accounting and payroll systems.

An important dimension of administrative capacity is the preparedness of agency managers to adopt change. Certainly, the budgeting and financial management methods used in the past are likely to be very different from those required by the new more market-oriented system. Hence those who had advanced to management positions in the old system may not be the most suited for the new. Given the evident skills required to implement the procedures described above, at a minimum one would have to recognize the need for an extensive and necessarily lengthy training process. One also might have to admit the need for a more basic restructuring of incentives in support of budget system reforms. Specifically, even larger scale administrative reforms may be required which will allow government pay scales to offer adequate incentives to attract and retain specialized skills.

The above review has also emphasized the connection between the macro and micro levels of reform. This raises the issue of how to ensure a balanced approach. While arguing that when reforming budget systems there may be no alternative to adopting a top-down approach and introducing the macro framework first, at the same time these macro reforms should not get out of gear with the capacity of the system to implement them. Certainly there is a concern that this has been the case in the past, and that there have been instances in which the
centralized institutions, by moving too far too fast, have seen reforms flounder and stall due to the lack of management capacity at the agency level.\textsuperscript{36}

There is also the related question of the strategy in introducing these reforms—should reforms at the micro level be introduced across-the-board or in stages? There are arguments for both approaches. Certainly going for a “big bang” approach has the advantage of using speed to overcome resistance, but implies a high risk of failure if there is a lack of suitable management capacity. A stages approach allows the gradual development of the necessary skills to make the reforms work, but will certainly take longer and may in the meantime allow organized bureaucratic resistance. Also an agency-by-agency approach increases the risk of micro reforms being stalled if individual agencies take long periods to implement new procedures and there are no visible benefits from reform. International experience, especially with budget system reform at lower levels of budget system development, would suggest caution in attempting the big bang approach.

The above considerations argue for coupling budget system reforms with management improvement at the agency level, and underline that the lack of basic management skills in government can be a binding constraint on the speed at which budget systems can be reformed, especially at the micro level. The old planning system and its associated traditional budgeting procedures required administrators not managers. In the old system controls were centralized and imposed from the topdown. Reforms envisaged at the micro level, discussed above, require a more bottom up focus and adequate management capacity at that level to be successful. Not only does this take time to create, but the well documented bureaucratic resistance to change will also need time and special skills to be overcome. This implies a second order of management skills—the need for central agencies when introducing budget system reforms to invest in developing a change management strategy and to recruit change management skills.

\textsuperscript{36} See discussion in Diamond, 2001.
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