

# International Studies Program

Working Paper 03-14  
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## Ethical Dimensions of Public Expenditure Management

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# Ethical Dimensions of Public Expenditure Management

Although there are no standards, there are generally accepted ethical principles. Experience shows that their non-observance may have contributed to policy distortions, uneconomic practices, consolidation of the unaccountable bureaucratic state, and to continuing fiscal crises in many governments. The achievement of the goal of a civic society requires the formulation and observance of an ethical code on the part of the government, and the development of adequate management tools that facilitate this monumental task. Recent efforts by international financial institutions (IFIs) in this direction do not address these issues and even if their recommendations are implemented in full, there would be no relief from the original sins. Part I of the paper explains the nature of the sins and Part II considers the alternatives proposed and their viability.

*A. Premchand*

*“It is clear that ethics cannot be put into words. Ethics is transcendental”*

*Wittgenstein, Tractatus*

*“The fault, dear Brutus, is not in our stars, but in ourselves”*

*Shakespeare, Julius Caesar*

The ethical dimensions of public expenditure management (PEM), which essentially deal with the expected patterns of behavior or professional conduct in regard to what we value the most- an objective and reasonable assessment of policy proposals and their alternatives, as well as appropriate implementation of policies, -have never received the attention due, notwithstanding the growing recognition of the crucial place

of PEM in the functional approaches and work of public bodies. Rather, far too much attention has been paid to corruption, particularly since that issue has come to take an important place in the conditionality and associated lending approaches of international financial institutions. The focus on corruption, important though it is, may have deflected the attention from the equally important and much needed exploration of the ethnical dimensions of PEM. The lack of attention may be ascribed to several obvious factors. The processes of PEM are largely related to the internal flow of information and its processing through various layers of governmental hierarchy, and the multiple dimensions of these processes, remains for the most part, outside the record of public debate. Rather it has remained a subject that is often discussed within the cloistered confines of government ministries. In part, it is also due to the lack of coherence on the part of those who are at the receiving end of government actions. The beneficiaries of government policies, along with those who claim to be victims, come from different groups of political spectrum, income levels, economic and social backgrounds, and have rarely found unity among them. The various interests occasionally come together and may even form temporary alliances to achieve common ends, but the divergence in their interests, does not permit a continuing unified front. Yet another factor may have been the narrow focus of some of the academic disciplines in examining the conduct of governments in the formulation and implementation of public policies. For example, the political scientists have addressed the issues relating to the participation of citizens in policymaking, and how policymaking in general could be improved, as well as the provision of public services on more efficient lines. The macroeconomists, on the other hand were more concerned with the impact of budgets on economic stability, and whether some of the normal proclivities associated with governments, could be controlled through constitutional amendments, legislation, binding rules etc. <sup>1</sup> Inevitably, in the process, some of the more important issues came to be left out.

Meanwhile, the lack of coherent, logical and rational processes has contributed to a higher incidence of human depravity with growing costs to the community. There are several compelling reasons now to consider these issues in some detail. First, there is the paradoxical situation, in which for reasons of fiscal stability and sustainability governments in industrial and developing countries, have been pursuing, some more

vigorously than others, policies aimed at reducing the role of the state and readjusting its boundaries. This cause has also been supported by the IFIs, who have become the most vocal supporters and funding agencies for the reengineering of governments. Even as these developments are taking place, there is also a growing emphasis on improving 'life satisfaction' and promoting more options for democratic involvement, as well as to ensure a more positive appraisal of public expenditure<sup>2</sup>. If this initiative were to gain more support in the future, it is a certainty that there will be more expenditure programs aimed at raising the level of life satisfaction, and at improved governance. Second' a similar paradox is found in the growing emphasis on the promotion of standards of public life. Ever since the Nolan Commission in the united kingdom (1994) reiterated the need for selflessness, integrity, objectivity, accountability, openness, honesty, and leadership (seven principles that were also openly endorsed and continued by the Blair government) there has been a growing perception that many of these qualities are found to be absent in day to day governmental management. Each time these or similar principles are enunciated from various fora, the public seems to be more assured that there is something crooked in the timber of the governments. Third, there is another paradox in that when the governments are claiming success in controlling expenditures and in improved delivery of services, as well as in enhanced user participation in public policy making, there is a growing deep seated distrust in the government. It is pointed out that while substantial advances have been made in establishing forms of welfare states, and in making obvious improvements in technological infrastructure, there has also been a steady increase, according to this perception, in the dominance of vested interests in policy making, in the rules and regulations governing the delivery of services to an extent leading to a tyranny of rules, and despite safeguards, there has also been a good deal of wasteful spending. Surveys carried out in various industrial countries reveal that this basic distrust is receiving, from time to time, additional adherents. In part, this reflects the changing landscape of the role of visual media, which brings the horrors of the effects of the governmental decision making to the citizens everyday. The citizens want improvements, and as yet they are not confident that the economic reforms and related financial adjustments are working in their favor. . It is the pervasive perception that governments engage in prevarication of facts, that they are more economical with truth

and that, in short, there has been a perceptible decline in the ethical standards of government, that makes a consideration of these issues important and immediate.

If future progress is to be made, it is important to stem the erosion that has taken place in the credibility of governments. A weak government, hobbled by its own internal systematic vulnerabilities and a growing lack of trust on the part of the public, can hardly be considered as adequately equipped to deal with the multiple growing expectations on the one hand and the stark realities of life, on the other. Samuelson wrote more than five decades ago, in a private memo to the then President-elect Kennedy, "Even an ostrich cannot avoid the economic realities of life". It cannot avoid the declining abilities of the governments to perform too, and immediate efforts are indicated' first of all, to restore the credibility of governments. Such a restoration requires concerted efforts on the part of the community, national authorities, and IFIs. A much-needed preliminary step in this direction is the consideration of the ethical dimensions of PEM.

The analytical framework here is divided into two parts. In the first part, the ethical dimensions of PEM, and, more important, those that are constantly abused or misused by governments and how those deviations contribute to distorted policymaking and related implementation, are considered. Part two is devoted to a consideration of the alternatives pursued by the national authorities and the IFIs and it is argued that many of the initiatives would hardly make a dent in the present situation even if they are fully implemented, and would hardly have the desired impact on improving PEM. Rather it is important to begin thinking of developing ethical codes, and countervailing powers so that a responsive and responsible, and most important, a credible government is restored.

#### Public Policy Making::

It is generally accepted that all public policy making, regardless of the final shape it takes either in the form of a separate statement or as a part of the annual budget, or a presidential speech, or the birthday occasion of the monarch or the prime minister, or as a separate piece of legislation, is the result of interplay of facts, values and interests. In theory, each of these groups are separate, and to a large extent objective too. In particular, facts refer to those phenomenon that are empirical and verifiable while values and interests are largely the products of thinking and are relative to every human being, and

as Kant pointed out a long time ago such values are unlikely to be objective. But this distinction between “objectivity and “relativism” of values may not be sustainable in the form of a clear boundary. In fact, many ‘factual’ statements may also be value statements, and to that extent, there may not be a fundamental political divide between the two<sup>3</sup>. The values are often relative to the subject of cultural groups, and it is important to recognize, that government does not represent a single culture. Governments are huge organizations comprising several domains, that are distinct, and that have separate value systems. Policy analysts have often divided the government, with a view to identifying the role of private interests in national policymaking, in terms of four sectors – Agriculture, Energy, Health and Labor. <sup>4</sup> Admittedly, this is too inadequate and hardly representative of the several other important areas such as defense, social services, economic infrastructure etc. Each of these domains tend to develop, like every human being, a set of their own values through which they evaluate the policies of governments. These values tend to be very general and stable over a period. Both the general nature and enduring stability form the hard core of beliefs and begin to dominate the thinking of every official entering into the distinctive domains of government. The terms ‘defense mentality’ ‘finance mentality’ frequently used in governments reflect the respective subcultures and their dominant value systems. These values become so ingrained over a period of time that they to affect the objectivity of the decision made or policies formulated.

In democratic societies, the initiatives in regard to public policies may come from a variety of sources that include the executive, judicial pronouncements particularly in countries where the judiciary plays an active role, findings and recommendations of independent commissions of inquiry, the legislatures, active public groups and during more recent years, on the advice of IFIs. It is noteworthy that in countries, which are heavily indebted to external creditors, the creditors also play an important role in the promotion of economic policies and related regulation. When the initiatives are taken from outside the executive wing, several factors may be at play including the vested interests that have a specific policy outcome in view. When, however the policy advice comes from independent commissions of inquiry, or from judicial sources, the normal impression is that their recommendations are objective and have not been contaminated

by political considerations. Regardless of the origin of the proposed policies, all policies that have financial implications, require the explicit support of the executive before they can become operational. Under the British type of parliamentary systems, no money bills can be proposed for legislative approval except at the initiative of the government. Since all policies have some financial implications – minor or heavy, recurring or irregular, they have to be considered and endorsed by the executive wing of the government if they have to become laws and moneys are to be appropriated by the legislature.

Once the initiatives are brought within the reach of the executives, there are specified and unspecified ways of processing them in the government. In each domain, the systems, and the individual groups are different and they may not fit into preconceived neat logical categories. Frequently the real world may never function according to normally held beliefs and there are blends, coalitions, incongruities and irrationalities that are not easy to explain. Bismarck is reported to have remarked that watching a legislature (or executive) make laws (policies) is like watching a butcher make sausages, unpleasant, routine and dull. The executive is basically concerned with the internalization of the four basic roles of policy- a political role of meeting a part of the ideological framework of the party in power, a problem solving role, in that it is addressed to a problem or a group of homogeneous problems, a judicial role in that the benefits of the proposed policy do not accrue unfairly to groups of people and that the distributional effects would be in accord with the expectations of the community of what is perceived to be fair,<sup>5</sup> and a specified role for the community which is expected to make financial sacrifices in support of the proposed policies or engage in other forms of contribution. In turn, they assure the community implicitly that the proposed policies would be cost effective and that they reflect, the intent and design, and aspirations of the community.

Notwithstanding differences among various governments and their operational systems, there are some common features associated with policymaking. The administrative systems are large and elaborate, and have their own internal control processes. Most of them reveal, in day-to-day practice, the existence of an oligarchy of institutions and an oligarchy of individuals that are responsible for government wide, as distinct from specific sectoral policies, policies that have far-reaching effects.

These institutions and individuals ensure that the centers of powers, influence, and responsibility are regularly in the picture through established formal procedures or through informal networks. Thus, the political interest groups, civil service interest groups, influential legislatures, go-betweens from the government and the corporate sector, external creditors, and the IFI's, are regularly consulted. Experience shows that the large range of government products and services have spawned several powerful organized interests such as the military industrial complex, construction complex, social service complex, poverty complex, etc, each with its own clientele groups and distinct forms of support. Public policy making as a system is neither white magic nor black, neither a formula for easy salvation nor a sanctimonious fraud. Its tools and operational systems are to be judged by the results separating ideas from fact, intent from outcome and viewed as a self-contained system. As a system, it can be sharp, timely, judicious and effective. It can also produce policies that are poor in design and therefore contributing to results that are expensive, and far different from those anticipated. The strategies and decisions may, at times' reflecting the numerous factors at work, be excessively value laden or have short term political ends in view and therefore have the potential of becoming more controversial with the distinct possibility that the remedy may be worse than the malady. Each public policy also involves an explicit choice and selection from among the various instruments that form the arsenal of PEM.

Conceptually, governments can achieve their policy objectives through direct expenditures, or provision of loans, or provision of fiscal incentives by foregoing the taxes due, or through public-private partnerships, or provision of guarantees, or through quasi-fiscal accounts maintained at the central banks and usually financed from their reserve funds. These instruments are not perfectly substitutable to each other, and therefore the final choice may reveal an eclectic combination of these instruments rather than an exclusive reliance on any one of them. It is best to view them as comprising a portfolio, where each instrument may be deployed to its potential. Each instrument brings with it a discipline of its own and distinct from others. To that extent, there is no single generic phrase generally used to describe the total phenomenon. Each instrument has its own implications for ethics, as well as for the most important relationship with the legislature, which in theory has the final control of the purse in an operational democracy.

Many of the instruments involve a departure from this principle of legislative control. The instruments may not also be available to all levels of governments; for example, quasi-fiscal accounts are not available to sub-national governments but are at the exclusive disposal of central governments.

In the academic approaches to this subject, a distinction is made between policy formulation and policy implementation. This has its origins in the contributions made by President Wilson in the United States nearly eight decades ago. According to his views, the world of government is neatly divided into spheres of policy formulation and policy implementation – the former being the exclusive territory of departments at the apex of the administration hierarchy, and the latter being the responsibility of the field or executive agencies. It is now generally held that this distinction is somewhat outmoded in that policies are made as they are implemented. Several changes may take place in the actual course of implementation and what becomes viewed as the policy is the one that is implemented. In the world of expenditure management, the transition from policy formulation to policy implementation, involves a shift of emphasis from allocative efficiency to technical efficiency, from funding to service provision, and the formulation of a more precise relationship between purchaser and provider of services. The ethical conduct of officials concerned with these aspects has a critical importance of its own in the overall process.

### **Principles and Protocol's:**

Expenditure policies of government are carried out, for the most part through an annual budget. The considerations of allocative and technical efficiency, as well as those relating to the maintenance of macroeconomic stability are expected to be kept in view while formulating the expenditure estimates of the budget. The ethical dimensions of formulation of expenditure estimates have, however, never been formalized in the form of a law nor has there been an established protocol, which if violated could be brought into the purview of the judiciary. Rather, they have been in the form of general principles expected to be followed by everybody concerned. The lack of legislation does not reduce their importance: on the other hand, they become a code of honor for those engaged in the formulation of expenditure estimates. These principles, which have grown over time,

and which have always been implicit, may be reiterated in terms of three categories<sup>6</sup> (a) Stewardship of resources: The estimates should facilitate an evaluation of the current state of finances and their future sustainability. Toward this end, the principles of unity or total comprehensiveness should pervade the preparation of estimates, and should therefore cover the financial implications of on-going and as well new policies, and current and long-term liabilities. Moreover, the estimates should be accurate for they imply a bond with the legislature which approves them, and more important, with the community. (b) Operational adequacy: the estimates and related financial information should enable an appraisal of the adequacy of the PEM machinery to deal with the current and future tasks of the government. As an integral part of this effort, it is expected that the tasks and responsibilities of governmental agencies are made abundantly clear; and (c) decision making approaches: the estimates are expected to be clear in their intent, and in the specification of intended beneficiaries so that the community and its elected representatives could understand and deliberate on the contents of expenditure estimates. The estimates should form a public document and be available in the public realm. These principles, which appear to be reasonable, should have been easier to be complied with. Experience however shows that departures from these principles have been more common than adherence. It is in this process of applying the principles that “original sins”<sup>7</sup> or ‘malcontents’ as Hertodus described them a long time ago, arise.

#### Original Sins:1

The application of the above principles does not necessarily mean that one would reach, as did Bacon’s crew of a sailing ship in his New Atlantis, and find a haven where the government is wise, generous and incorruptible. Rather, the intent is to examine how various choices are made and how ethics are observed in the day to day working of governments. A cursory examination of the fiscal experience shows that many choices of fiscal instruments are made deliberate in the knowledge that they may imply a departure from the accepted world of morality. The experience in this regard is best examined in terms of the framework described elsewhere,<sup>8</sup> viz- Resource allocation, resource utilization, and resource use accounting.

(i) Resource allocation:

(a) Instrument choice The first choice relates to the instruments of fiscal policy. If it is pursued through direct expenditures, it implies unambiguously, that the intent is to operate within the framework of traditional budget and its discipline. If the choice involves loans or guarantees, it could imply a short-term preference for the creation of a financial asset that may be more advantageous than direct expenditure, while a guarantee may take the matter totally outside the budget. To that extent, it could involve, in the absence of adequate legislation or similar safeguard, the emergence of the issue of moral hazard. Further, what is granted as a loan has every possibility of being converted into a grant or may be written off. Reliance, on the other hand, on quasi-fiscal accounts, may once for all take decision-making outside the realm of annual budget, and associated legislative control.

H.L.A Hart wrote that ‘men are neither angels nor devils: that makes morality both necessary and possible’. The experience in regard to the choice of instruments, particularly during the last three decades, of both industrial and developing countries shows, that the behavior, in the absence of formal legislation has been far from angelic. In fact many of them plumped for the creation of autonomous agencies that were financed either by loans from government or by guarantees given by it. In reality, many loans were non-performing from the day they were given and guarantees in several cases, meant redemption of a deferred liability. Similarly, in regard to public-private partnerships, the fiscal risk remained for the most part with the governments. In the absence of efforts to reduce or distribute the final risk, additional liabilities became a common feature of governments at all levels. A likewise expansion in tax expenditures reduced the tax base of governments, while the results of those incentives remained debatable. Many of the financial crises experienced by governments can be explained in terms of the wrong choice made at this stage.

(b) Estimational fraud.

The annual decision-making in regard to the determination of aggregate expenditures, as well as sectoral allocations is expected to take place within a specified macroeconomic framework. The determination of the funding is done in terms of

continuing policies and new programs and projects. The eligibility of the latter category for funding is very much dependent on the availability of additional resources in the form of current account surpluses or external loans from IFIs. In both cases, it is common in the industrial and developing worlds, that attempts are made as indicated above either to escape the scrutiny that normal budget discipline entails, or to understate the financial implications every where. Most policy making seems to follow a predictable pattern. First a crisis is created; second, pressure is brought on the government to find an immediate way-out, as the alternative of inaction was going to be a major economic disaster, and third, governments are persuaded to begin making budgetary allocation to fund the proposed alternative.<sup>9</sup> In this context, understatement of costs serves the vested interests, while providing an easy and smooth path for decision making. All of them realize that once a project or a program is included in the budget and an allocation however small, has been made, it gains legitimacy and a momentum of its own that is difficult to stop. It raises expectations, leads to the establishment of formal or informal client groups that very soon become entrenched interests, and it becomes difficult even to contemplate an abandonment of those projects or programs. Similar approaches govern the inclusion of mega projects, A recent analyses of fifteen mega projects undertaken in several countries shows that decisions were not made on the basis of 'honest numbers' and that "project promoters often avoid and violate established practices of good governance, transparency, and participation, in political and administrative decision making either out of ignorance or because they see such practices as counter-productive to getting projects started".<sup>10</sup> The result of this myopic decision making is that "cost overruns and lower-than predicted revenues frequently place project viability at risk and redefine projects that were initially promoted as effective vehicles to economic growth as possible obstacles to such growth."<sup>11</sup>

It is also observed that a bout of undue optimism takes over the budget decision makers in the process of making the annual budget. In an attempt often motivated by a desire to influence the market, and the community, governments tend to engage in manipulating the estimates to achieve a desired level of deficit. In turn, this could imply inflation of revenue estimates and a downward estimate of expenditure. Since the Reagan years, these two approaches have come to be embodied in the budgetary lexicon as 'rosy

scenarios' and magic asterisks (expenditure reductions will be announced later, the footnotes explain). But as the year progresses, recognition of the reality dawns on the policy makers, and the rest of the fiscal year is spent in making adjustments, in some countries, even on a daily basis. The annual budget presented, approved and enacted into law by the legislature, then becomes a putative budget, and budgetary decision making, ceasing to be an annual rite, becomes a daily scramble for resources. Instead of certainty, it engenders on a regular basis, uncertainty in the availability of resources. More significantly, the adjustment process becomes a power play in which those who are protected in terms of special categories such as wages, pensions, or military, or those who thump the table harder, or those with political clout, end up getting more funds. What was expected to be an objective, and relatively a technical exercise becomes loaded with political side-shows and decision-making that may be anything other than ethical.

The understatement of outlays (the phrase 'costs' is deliberately avoided here, as in most cases of programs costs are rarely computed in governments. Costs of projects are computed, however, even if on a tentative basis, as they are often submitted to donors and IFIs for financing) has other major implications for allocation of resources. Those who get a toe hold in the budget begin after a stage to claim more resources than have been originally estimated, and gradually crowd out, the admission of other deserving projects. Furthermore, since the initial estimates are understated, there would be no strong desire or effort to secure savings at the design stage. A more serious matter of concern is that the understatement of costs as well as other aspects, may end up in the government playing the role of a toady to the corporate sector, particularly in the area of medical research and associated development of drugs. A recent study on science and politics in the United States reported that "mercenary motives were sometimes involved in these episodes of fabrication, falsification and plagiarism- the formally proscribed categories of scientific sins".<sup>12</sup> Such motives are common to several other areas whose estimates are routinely manipulated for a specified remuneration.

Those who are engaged in the management of government finances may offer two explanations in support of this approach, which has almost become second nature to them and has come to be firmly ingrained in their psyche. First' is the state of knowledge regarding the project or program under consideration. In this regard, a case has been

made a long time ago by Aristotle, who wrote in The Nicomachean Ethics that “it is the mark of trained mind never to expect more precision in the treatment of any subject than the nature of that subject permits”. The inadequate knowledge and related database can often be major factors in sharply limiting the capacity of the policy maker in carefully examining all aspects including the possible changes in economic parameters such as exchange and interest rates. Preparation of estimates is based on the knowledge available when those estimates are prepared. While changes can be factored in it is difficult to be too precise about the possible changes throughout the life cycle of a program or a project. Although the theoretical base of the argument cannot be denied, the more important issue is whether this factor alone explains the major difference between intent and outcome. It is here that the second factor assumes importance. Second, it is the tradition of estimate making that governments wishing to advocate a policy always underestimate the costs and overestimate the benefits. The spending agencies routinely underestimate costs, and to acquire legitimacy, they even commission studies by external consultants who deploy their scientific tools to cover up the truth. There would appear to be radical differences in the approaches between a medical doctor, a historian and a government analyst. A doctor concedes that his diagnosis is fallible given the mystery of the disease and the uncertainty of its mutation. A historian may admit possibilities of different interpretations as more light may be thrown by subsequent researchers. A government analyst, however, rarely entertains doubts about his own approaches or his estimates. If doubts are entertained, then nobody would trust the government. An analyst in government therefore starts, more often than not, with a goal that has already been defined, and analysis is just a way to get it through the various stages of consideration. In reality, these stages may not add to value, as what is done in each successive stage is to ratify what was approved in the previous stage. To gain that first stage approval, the analyst may be economical with truth and may believe what he/she wants to believe. In the process, truth may change colors depending on the need to be served. Since people expect error-proof statements from governments, repeated assertions are made in public about the thoroughness of enquiry and about the sanctity of the findings. In essence, it becomes a sideshow, gathering its own momentum depending on what is proposed.

Meanwhile, the start made with a wrong premise, subverts the expenditure management process.

(c) Secrecy. The process of decision-making in governments reveals several features that tend to solidify the prevailing degree of centralization and associated veil of secrecy. In several countries, the determination of expenditure programs and their allocations continues to be carried out in utmost secrecy, which is a direct violation of one of the principles listed earlier. Further, there are some protected or reserved categories, such as defense where even the aggregate, let alone the programs and activities, expenditures may not be revealed to the public. Similarly, negotiations about the projects and programs to be funded by external donors are often carried out in utmost secrecy, and information is selectively released to the community only after the deals have been concluded. This implies that the public voice may not be heard until after the final decisions have been made. To that extent, the process reveals an absence of a constructive and open manner for consultation with the public; In some cases where arrangements are made to consult the public, the discussions may be dominated by the organized vested interests, while the poor and less educated sections of the society remain politically unorganized and therefore weak.

To avoid this, a few countries such as the U.K, have taken to the issue of green papers containing the proposals on which the reactions of public are solicited. In one state in India (Andhra Pradesh, in 2003) a radical departure from the previous tradition was made and a draft budget was placed in the public realm for soliciting reactions of the citizen. While this step was a progressive one, the discussion was dominated in the event by the organized political interests both inside and outside the legislature. It is not clear whether the feedback had resulted in any major reversals or modifications in policies.

(ii) Resource utilization

(d) Shortage induced behavior

Many of the above problems continue to affect fiscal management during the budget implementation phase. Since many of the estimates tend to be based on optimistic forecasts, it soon becomes necessary for the decision makers, to scale down their expectations and to adjust to the changing realities. In most cases, this takes the form of

underfunding in that the final release of funds to the spending agencies may be substantially less than indicated in the approved budget estimates. In turn, this calls for a kind of reverse budgeting in the agencies, which many of them find it difficult to do in a meaningful manner in a context of heavy backlog of commitments. Their annual vision is mostly regulated by the provision in the budget, and when that provision gets reduced through informal means, the agencies find it more convenient to accumulate arrears in payments. The arrears so piled up reflect involuntary lending on the part of the creditor at zero rates of interest. Because the government flexes its muscles as the single biggest buyer in the economy, the creditors accommodate them but at a price, in that their original quotation for supply would also include the risk premium for non-payment in time. This has also an impact on the creditworthiness of the government in that it may have to pay a higher interest rate when resorting to borrowing from the public. To that extent, the transactions become more expensive at the very juncture where technical efficiency is sought to be achieved through marginal adjustments in the implementation of programs. The original sins contribute to continued distortions in decision-making. Underfunding also leads to major changes in the way services are provided to the public. In hospitals, clinical tests may be limited, not on the basis of the severity of illness, but on the basis of perceived power base of the client. Invariably, it is the ill-educated, ill-equipped poor who tend to suffer in the process when in the name of discretionary action towards fiscal adjustment, they get excluded from the service grid. Here again, some categories of expenditure escape the proposed adjustment, even if they are less urgent than some others, by virtue of exclusive funding arrangements, such as with the donors. These programs get implemented as proposed, while the locally financed projects and programs would be subjected to severe reductions.

e) Year-end evasions: It is common experience that substantial segments of the annual budget get spent during the last quarter and the last month of the fiscal year. Since the allocation for the next year may be partly based on the rate of spending during the current year, the agencies struggle hard to utilize the full (or reduced) allocations by the end of the fiscal year. This pattern of behavior has not changed much even in countries such as Malaysia, which has recently adopted a form of biennial budgeting. In these cases, where

the amounts are shown as spent, they may not in reality, be spent but may be transferred to other accounts frequently called deposit or personal ledger accounts, to be spent in the following years. This practice, which is common in the Indian Sub-continent and in some of the British Commonwealth countries, involves features that are very problematic. It starts with a falsehood, in that the amounts are claimed to have been spent whereas they are notionally transferred to another account. It also leads to the creation of a parallel budget, that is outside the purview of the legislature, and in many cases, from the audit too. In effect, it becomes a clandestine operation that is regulated by the finance department and the concerned agency.

(f) Contracting out: Contracts have an important role in the process of budget implementation; the supplies of materials needed for internal consumption by the government are routinely arranged through procurement contracts. Since the early 90's, and as a part of the introduction of new public management philosophy advocated by the IFIs, the scope of contracts has been considerably expanded, and includes, the contracts for personnel services, contracts in regard to public-private partnerships, and contracts with regulatory agencies. In fact contracting out has become a core technique of today's government. In the early years of its introduction, particularly after the experience of New Zealand, this technique came to be increasingly supported by IFIs as a way of reducing the size of government. Its legality, however, was not examined in any detail. It now transpires that this technique has doubtful legal standing. Davies Anne, (2001), points out, in a very detailed analyses, that contracting out reflects a failure of both the constitutional law and administrative law. The study reveals that the legislature has little involvement in a discussion of contracts either as a policy instrument or in specific instances. Her conclusion is that "the failure of constitutional law to control government by contract means that it lacks democratic legitimacy".<sup>13</sup> Similarly internal contracts such as between the provider and purchaser, when both parties are from the government, she finds that they "are not subject to any law at all, administrative or private"<sup>14</sup>. Where services are provided by corporate firms, the details of contracts may be claimed to be commercially confidential, and the judicial system may not permit the audit office full access into the records as happened in Canada<sup>15</sup>. It emerges from this exhaustive legal

analysis, that in their eagerness to promote market pressures, the proponents of government by contract, may have taken up an area, where in addition to potentially reducing public accountability it raises a legal hornet's nest, and raises the more important, and as yet, unanswered, issue, whether contracts should be used to enforce social goals. These issues can be answered only when there is a well-designed contracting policy supported by an accepted legal framework. Meanwhile this aspect, which is not considered legal, cannot be deemed ethical.

(g) Implicit contract with the community: The annual budget implies a profound agreement with the community about the benefits that are sought to be provided to it. In the process of utilization of the allocated resources, governmental actions tend to be affected, depending on the area of operation, by a wide variety of forces; changes made by force of circumstances, political or economic, ought therefore to be conveyed to the community at an early stage so that as economic agents, the members of the community may make necessary changes in their own behavior. But this has been rendered difficult due to the absence of a detailed agreement in the first place, and secondly, due to the fact that changes, such as underfunding, may be made at executive discretion, and may not be known to the public until after the fiscal year is closed. This creates another choice between the ethical obligation to periodically report on the discretionary action taken by the government, and the need of the government to be selectively secretive about its operations. Hitherto many governments have opted towards the latter, with the inevitable consequence that the ethical obligation came to be neglected or ignored.

(iii) Resource- use accounting: Governments are expected to provide information on the ways in which the allocated resources have been used. Traditionally this was sought to be served through the submission of audited annual accounts to the legislature either for information, or where legally required, for its approval. More recently, several countries have also accepted the obligation of intra-year reporting, mostly on a monthly basis, in accordance with internationally accepted standards. It should be noted, however, that this information is totally financial in nature and does not throw any light on the service benefits accruing to the community. As will be discussed further on, the design of this

monthly reporting was intended to meet the need of the investing class, and not for the broader community. Moreover, monthly reports on government tend to be misleading for a major part of the fiscal year, as the more dominant developments with significant effect on the annual budgetary outcome tend to take place in the last month of the fiscal year.

The interests of the community in seeking resource use reports is to ascertain how its heterogeneous demands have been met, how the conflicts in implementation were resolved, how they have been affected by the political, social and economic events, and, finally, whether the operational systems have been adequate to meet the diverse requirements of managing the economy and the provision of the resources. From these points of views, government accounts have proved to be a total failure of intent. The accounts, in several cases, are too brief or too elaborate, incomplete in many cases and provided in a format that is certainly not intended for the illumination of the common man who is supposed to be the main client. Even if it is intended to a legislator, it has to be recognized that his understanding is not very different from that of the common man. In the process, accounts are prepared by one set of specialists, for another set of specialists who then comment on them, to be taken up pro forma by one of the legislative comities later.. This ritual, although well intended has since lost sight of its main client, and many of the issues raised above remain to be answered.

The preceding survey shows that PEM has come to be excessively manipulated by the executive to an extent that some of the original intents have been subverted. The skewed decision-making, having its origins in unfounded optimism, contributes to a yearlong adjustment effort, and to frequent failures in the provision of services. There has been, as a result, an extensive shift in day-to-day management, of power into the hands of the executive. Its machinery its found wanting in several respects to achieve the purposes for which it was originally designed. Government's ability and capacity to break the law is only matched by its capacity to make laws. Its actions, in the name of secrecy, technical expediency, leave a good deal to be desired.. Complacency at this stage would only accelerate the journey, which is already headed downhill. It is in this context that the alternatives proposed need to be considered.

Alternative proposals:.

During the past decade, several proposals have been made, and are continuing to be made, aimed at the improvement in a general fashion, of PEM systems in various countries. The impetus for this came from the larger effort aimed at improved governance, and therefore improved institutions, operational systems and related techniques. In analyzing the alternative proposals for improvement, two features need to be noted at the very outset. First, the problems described above, have not been identified in this specific manner anytime before; When the ‘Washington Consensus’ was forged, there was a general recognition that many of the PEM systems have not been effective in serving the fiscal policy purposes and were there in need of improvement along with systemic improvement in tax administration, and in the policy approaches towards state owned enterprises. Within this framework, the IFI’s developed their own areas of expertise and professional specialization. The diagnosis of these institutions differs from original sins described earlier. That said, there are many ingredients of the IFIs framework that have an impact in avoiding some of the above problems. Second, in addition to the IFI’s, there have been some independent proposals too, which together constitute the total set of alternatives available for consideration by those engaged in institutional improvement.

For analytical convenience, however, the alternative proposals may be examined in terms of four broad groups, viz- (a) Rules and fiscal responsibility legislation (b) identification of risks, (c) transparency and accountability and (d) infrastructure development.

(a) Rules and Fiscal Responsibility legislation: The establishment of a civic society and its continued smooth functioning require, at a minimum, the rule of the law. The general contention is that the existing laws have not been effective in checking the egregious errors of public expenditure management which is seen as having largely been manipulated by powerful political interests that are primarily guided by their short term goals. To check this, appropriate rules have to be established. Rules in government have been devised for a variety of purposes. First, from the point of view of the public choice theory, it is the monopoly power of the government which has contributed to a form of

tyranny, and if that is to be avoided, rules have to be established aimed at checking the proclivities of governments. The rules aim at limiting the power of coercion of the government.<sup>16</sup> Second, rules seek a fair allocation of power among the various agencies of the executive wing of governance. Third, rules seek to establish a kind of uniformity in approaches, in a context, where there is a multiplicity of policy and decision makers. Fourth, rules are distinct from principles in that they have an element of control on what an individual or group of officials can do and finally, rules can prevent political intervention, paving the way for a more smooth functioning of the bureaucracy. Rules may not be needed in all cases or countries, as the same purpose may also be served by the common law system. Rules, inevitably, can have their own rigidity, as there are limits on their inventiveness, nor are they error proof. To that extent, the application of a rule could also mean the application of the theory of the second best.<sup>17</sup> In recognition of the general virtues of rules, it has been suggested that the credibility of fiscal policy stands to be considerably enhanced, if the goals of government are specified in some detail in the form of a law, so that the possibility of discretionary intervention, could be minimized. Although the annual budget, which embodies the policies of government, is itself enacted into a law, the suggestion was that broader supplementary legislation would add credibility to government actions.

It was for this purpose, that fiscal responsibility legislation, containing the principles of prudent fiscal management, was enacted by New Zealand, in 1994. Although there were precedents in the form of stability and growth acts in what was then West Germany, in the 60's, the initiative taken by New Zealand, came to acquire unusual importance, and a belief has gained ground to the effect, that the IFIs would prefer the New Zealand model to be adopted by other countries. As a result, several countries, ranging from Argentina to Peru, have enacted fiscal responsibility legislation, and a few more, including India (as well as some state governments in India) are in the process of attempting variants of this approach. The content of legislation and the rules that follow differ from one country to another. In New Zealand, the formal legislation is nothing more than a reiteration of the need for pursuit of prudent fiscal policies, and a major part of the operational framework is contained in the annual specification of medium-term fiscal policies. Elsewhere, there are formal limits to increases in the fiscal burden, and ad-

hoc ceilings on nominal rates, and ceilings on specific categories, as well as the general level of public expenditure.

Although the experience with this approach is rather limited, several questions arise that need to be answered at this stage. Does this legislation add to the credibility of government? The answer is, it depends on what is contained in the legislation and how adequate it is to address a specific situation in a country. For example, Argentina enacted no-deficit legislation in furtherance of the fiscal responsibility principles in 2001, at the height of its economic crises. Nevertheless, this action did not win any support from the market forces, which saw that as a cover-up, and as not providing a viable solution to the fiscal problems. More recent analysis suggests that much is dependent on the actual content of the specific measures taken than on umbrella legislation. It also points that the “rules may be helpful in achieving fiscal consolidation... but they are not clearly necessary in all countries”

A second issue is whether enactment of rules would by itself bring about enforcement? Here again, experience is the best judge. Several countries had, in the past, many rules intended to influence budgetary decision making. Those included for example, the golden rule under which borrowing would be undertaken only for viable investment projects; yet another rule was intended to achieve a balanced budget. Some countries, notably Japan and Indonesia, among others, had this rule as part of their constitutions. Both rules were simple, and in a way beneficial, but both were increasingly disregarded in practice. Would the new legislation have some improved chances of implementation? In part, the answer to this depends on the penalties for violations of the proposed rules. In some cases, judicial sanctions may be issued, while in many cases, all that would involve is a loss of reputation that may affect the chances of reelection of the party in power. In judicial sanctions, it is often difficult to determine the responsible individual, particularly where the budget outcome becomes the reference point for determination on the extent of violation. In fact, excessive emphasis on the budget outcome may make government achieve that goal through illegal means, primarily through an accumulation of unpaid bills- another egregious ethical lapse referred to above.

Would not legislation make the whole powers more rigid and inflexible? Recent evidence with the experience of Maastricht countries shows, that the restrictive provisions about the national levels of deficit and outstanding debt, which were hailed as great achievements a decade ago are now being described as too inflexible to permit the much needed counter-cycled fiscal policies. At issue is whether these purposes could also be achieved by institutional development, more specifically, through the strengthening of policy formulation. The fiscal rules of the type discussed so far do not minimize the built in undue optimism, or the introduction of expenditure proposals into the budget without full consideration of their financial implications. The task of improving the policy formulation remains to be undertaken. Meanwhile, the responsibility legislation, which may have the educational effect of expanding the fiscal horizons of the community, would by itself not, avoid the original sins discussed.

(b) Risk Identification: The implementation of fiscal policy as embodied in the budget requires an explicit recognition of many of the forces, domestic and external, that have a direct influence on that process. A change in the exchange and interest rate could contribute to expenditure increases that in the absence of revenue mobilization efforts could contribute to higher than intended budget deficits. It is therefore urged by the IFI's and others that these risks be identified at the outset, in the hope that such an identification would be followed by formulation of strategies aimed at addressing them. While this is important, it has to be realized that risk is a far wider phenomenon in governmental operations that is commonly recognized.<sup>18</sup>

Apart from the macroeconomic risks, there are risks associated with major projects both in terms of potentially higher costs and lower benefits. Advocates of fiscal transparency drawn from the academic world, emphasize the need for informing the public about these risks.<sup>19</sup> In addition, there are unintended consequences of government policies that tend to affect some sections of the community than others. Further more, governments have responsibilities for creating a secure economic and financial environment for the citizens. There may include disaster relief, financial guarantees in the event of failure of financial institutions, environmental liabilities and others. In many developing countries, these aspects are addressed as they arise, which in several cases,

may be to late. Given the growing scope of these risks, public risk management becomes simply unavoidable and becomes a necessary part of governmental efforts at regulation, and more important, at making suitable arrangements for the possible reduction, or reallocation of risks.<sup>20</sup> In all these areas, more remains to be done in making institutional arrangements for the recognition, measurement and possible reductions of risk, as well as a more precise identification of their impact on public expenditure.

(c) Transparency and accountability: The functioning of a democracy has been viewed historically in several ways. In one way, it was viewed as oriented to the public good, and in doing so, public debate shapes the public policy in a consensual fashion, and that every citizen recognizes his/her public obligation. In more practical terms, democracy has been viewed largely in economic terms as competition among diverse interests and in which the stronger group gets to make public policies, mostly intended to further its own interests. The concept of civic society, although has not been properly defined, is largely derived from the former approach. In either case, public policy requires the preparation and dissemination of large data that are expected to illumine the issues and facilitate decision-making by economic agents. Such information tends to be more objective in the first type of democracy, while in the second, the vested interests might be more inclined to manage the data that are supportive of their design. While information covers a large area, and is coterminous with the scope of public policy, the efforts of IFIs have been largely limited to the organization and provision of fiscal information. These institutions have not however been equally engaged in the development of accountability systems, presumably under the impression, that the dissemination of information would by itself, create pressures for the creation of proper channels of accountability and their effective functioning. In regard to fiscal transparency, a manual has been issued, while no similar effort has been made in regard to accountability.<sup>21</sup>

The manual on fiscal transparency attempts to delineate the roles and responsibilities of various levels of government, the nature and coverage of fiscal information (which should be complete, verifiable and made available in a form that permits in-depth analyses) and the adequacy of the fiscal management machinery responsible for the fiscal conduct of the government. The attempt, while laudable,

presents some general issues, as well as more specific issues relating to PEM. In general, the effort is more geared to that section of the public, which is engaged in investment in government and debt instruments, eg. the financial class. The manual makes a feeble attempt to touch on the delivery of services and the need for performance orientation but does not go into the subject. Its concerns remain limited to those of the financial class and not that of the general class. The manual proceeds in the belief that provision of information would itself make governments more accountable, although the long history of governments conclusively illustrates, that in the absence of oversight bodies, the usefulness of information would be severely limited. More important, while it is concerned with greater transparency in regard to the relationship between taxpayer and the tax administration, no effort has been made to examine the vast area of the implicit compact between the community and the government in regard to the nature, quantity, quality, cost and timeliness in the provision of public services. It is serious gap that remains to be filled up, more so in the context where the Transparency International is dredging up and publishing information on the payment of 'donations' for getting children admitted in schools, or payments for getting admissions into hospitals.

Similarly, accountability has been viewed in very narrow terms, dealing mostly with the financial accountability, which was the conventional domain of audit and related legislative committees in the British type systems. The content of general and managerial accountability remains unexplored, as are the limitations of conventional tools, or the factors hindering conventional accountability.<sup>22</sup> The overall issue is whether transparency by itself would have the potential impact of transforming the PEM and making it more honest. Experience of many industrial countries shows, that the original sins referred to above, have no less an incidence in the fiscally transparent democracies than elsewhere. The attempts made by the IFI's constitute, at best, a beginning and certainly not the last word on these important areas.

(d) Infrastructure development: The suggestions for improvement and on going efforts, may be considered in terms of three components- (a) computerization of PEM, and related accounting systems; (b) introduction of multi-year expenditure forecasts or medium term expenditure frameworks (MTEF), and (c) introduction of accrual systems

for budgeting and accounts. Of these, the first requires no detailed explanation of the underlying approach or rationale. Rather it is the experience, which reveals a mixed picture. In several African countries, the experience reveals that in their eagerness to move on to a computerized system, manual records were discarded leading to severe problems in their operation. In some cases, the system was far too elaborate than the local needs implied. While these teething troubles are inevitable, there is no gainsaying the need for the application of electronic technology to this area, as the experience of several other countries, including the former centrally planned economies in Eastern Europe and elsewhere, reveals the extensive beneficial results from technology.

The MTEF, which is now usually insisted upon by the IFIs in all the borrowing countries is essentially intended to promote improved policy formulation over the medium term. Toward this end, a rolling MTEF is expected to be prepared each year for the next three (or more) years, showing the future financial implications of current and new policies. In principle, this approach has the potential of clarifying the continuing draft of future resources from current policies and the margins available for expansion or alternatively the range of reductions needed. In practice, however, its utility has been considerably reduced in view of the limited coverage of the system (contingent liabilities are not covered) and the technique used for forecasting (mostly simple projections without detailed policy planning) Moreover, MTEF would have only a limited role except in the context of a medium term fiscal policy. Experience also shows that, in both industrial and developing countries, there is frequently an attempt to manipulate even these estimates in that whenever reductions or savings in expenditure are to be made, they are shown in the latter years.

The limitations of the cash based system for budgeting and accounting have been recognized for quite some time. Essentially, they do not reveal the complete financial picture, nor do they permit the computation of the cost of programs and activities. But the introduction of accrual budgeting and accounting systems which record transactions at the time firm commitments are made, regardless of the fact when actual payments are made, are considered to be more useful, particularly when depreciation accounts are also maintained. Such an introduction has been facilitated by the computerization of accounts, which permits the maintenance of data in terms of a variety of bases. Some, however

contend that full accrual accounting is not necessary in a non-profit organization like government and have therefore opted for a modified accrual system i.e. without depreciation accounts. While accrual budgeting and accounting systems have the potential of providing a broader picture of government finances in terms of assets, liabilities, and contingent liabilities, they are not totally immune to the excessive optimism shown in the formulation of estimates of either current policies or new initiatives. They do not also address the issue of the compact between the taxpayer (or the wider community) and the government on expenditure benefits.

Toward improvement and sustainability:

The preceding analysis illustrates the fundamental gap between the available instruments and the desired ends of civic society. Even where instruments exist, they are subject to extensive subversion by the executive wing of governments. But the situation cannot clearly be allowed to continue for it could only mean an approval of the continued ethical violations witnessed in daily life. The issue is not merely one of instruments, but also one of the failures of oversight mechanisms that were specifically aimed at preventing extensive subversion. Over the years, however, there has been a steady decline in the legislative power, and the real decision making power has moved to the bureaucracy. It is no more a case of choice between accountable bureaucracies or a civic society with established channels for public participation: if the latter is to be achieved, there should first be clarity about the purposes. From this point of view, it is essential to restore the credibility of governmental systems by formulating a program aimed at achieving improved PEM. Such a program should necessarily include (a) improved internal control systems (b) restoration of balance between the executive and the legislature (c) supplementing legislative oversight with a layer of social audit; (d) development of an ethical code for governments to follow, (e) establishment of effective channels for public participation, and (f) development of a public expenditure compact specifying the services to be provided between governments and the society. This is an agenda that is far wider, and necessarily so, than the one sponsored and largely funded by the IFIs the fiscal responsibility for seeking improvement rests with the people of a country. External stimulus has many limitations of its own.

The main or the critical question, as Bok has mentioned is “how much effort citizens are prepared to make to help their government function effectively”<sup>23</sup>. The paradox in this context is “the wide and growing wide divergence between the meager effort citizens devote to politics and public affairs and the pervasive influence that governmental policies have on their lives and that they in turn have on their government”.

<sup>24</sup> The only way in which the paradox can be eliminated is through the gradual recognition, by the community that its role is too important to be neglected, and that continued neglect would exact a heavy price from the community. In due course, with gradual demystification of the PEM process, the community will develop its own expectations, priorities and more important, the development of the channels through which informed public opinion would be felt.

### **Notes.**

<sup>1</sup> In the early 80's there was a doubt, even among responsible policy makers, whether there was in fact a proper budget policy. David Stockman, then the director of office of management and Budget in the U.S. government, said his response about budget policy was to remind the words of Mahatma Gandhi, when he was asked what he thought of western civilization, “it would be a good idea” replied he. See Feldstein (ed) 1994 P 270.

<sup>2</sup> See, for example, Donovan, Nicholas (2002)

<sup>3</sup> For a general discussion of these distinctions, see Hundert 00180-183

<sup>4</sup> See, for example, Heinz et al (1993)

<sup>5</sup> In several cases, these aspirations and expectations may be embodied in the form of constitutional provisions, See for example, Part IV of the Indian Constitution, containing the Directive Principles of State Policy, which being not enforceable in a court of law are ‘nevertheless fundamental in the governance of the country’. (emphasis added) The constitution and the laws do not, however, specify the organizational forms, institutions, and operational systems through which the goals are to be achieved. That is for the executive wing to develop the requisite tools that would hopefully convert the goal into reality.

<sup>6</sup> For a more detailed discussion of these aspects, see Premchand. (2003) P522.

<sup>7</sup> For a more detailed discussion of the theory of original sin or moral error, see Dunn (2000) P 19.

<sup>8</sup> For a discussion of this framework. See Premchand. (2000)

<sup>9</sup> For a very interesting case study of this approach, see Greenberg (2001). The subtitle of his book, ‘Political Triumph and ethical erosion’ is of particular interest.

<sup>10</sup> See Flybgiert and others, for more detailed analyses. P5 (2003)

<sup>11</sup> Ibid, P 3

<sup>12</sup> Seen Greenberg 349 (2001) Greenberg cites several cases of drug development where government sponsored academic research ended up supporting the case of drug manufactures through fabricated data. One way of avoiding this to develop a code of ethics in research, but those involved with these matters testify that the process will be time consuming and “even pointless if they (the scientific community) are not prepared to enforce what ever codes they adopt” (P352: emphasis ended) Those who are engaged in the discussion of the philosophical implications of these approaches point out the major difficulties in establishing the truth, which to them is a myth. While truth may have a liberating influence, the discovery of truth may also diminish human happiness. In an imperfect world, it is difficult to pursue truth for its own sake, as theologians have done it, the alternative, Kitcher argues (2001) is to work in ways that “approximate the requirements of well ordered in science, and where this is impossible, because of

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impotence and institutional entanglement, to do what they can to bring the practice of science closer to well “ordered science” (P197) He adds “ these obligations are especially clear at a time when scientific research is increasingly co-opted by entrepreneurs whose interests in profits is likely to have little to do with the tutored collective preferences of other citizens”. That well-ordered science remains however, a normative goal and the end is not yet sighted or even specified.

<sup>13</sup> Davis (2001) P 11

<sup>14</sup> Ibid, P11

<sup>15</sup> Nearly a decade ago the Auditor General of Canada filed a case in the Supreme Court against the Government of Canada seeking full details of a contract. The Supreme Court’s judgment was in favor of the government, which claimed that revelation has the potential of injuring the competitive commercial interests of the contractors.

<sup>16</sup> For a more detailed examination of this approach, see Hayek (1960), in particular, Chapter 15. (Economic policy and the Rule of Law), pp220-233.

<sup>17</sup> An examination of some of these aspects is found in Schauer (1991)

<sup>18</sup> Banca D’Italia, P 16 (2001)

<sup>19</sup> For a recent advocacy of this sort, see Flyvbjerg and others, (2003). This aspect is not touched upon by the IFI’s despite the extensive involvement of the world bank in the financing of projects.

<sup>20</sup> Moss provides an excellent account of one U.S experience in this regard (2002)

<sup>21</sup> See IMF (2001) It makes several references to accountability in a general fashion but does not deal with the subject in any detail. Also see World Bank (2000)

<sup>22</sup> A detailed account of these aspects is provided in Premchand (1999)

<sup>23</sup> Bok (2001), P384

<sup>24</sup> Ibid, P 390

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