Pro-poor financial management: The development and implementation of poverty oriented budgets in the wider context of public sector financial management

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1 INTRODUCTION

The development agenda has increasingly focused on the reduction of poverty. This trend is evident in the actions of individual governments and donors, and the development of Poverty Reduction Strategy Papers (PRSP), required for Highly Indebted Poor Country (HIPC) initiatives. This article addresses the financial management issues of pro-poor strategies. It goes beyond pro-poor budgeting to consider the financial management of revenues, assets and liabilities, accounting and auditing, and the linkage to requirements such as expenditure tracking and performance targets. The article starts with a discussion of poverty reduction strategies. It then moves to analyze specific areas in which financial management reforms are required to ensure an integrated approach to facilitate the development and implementation of poverty oriented budgets.

2 REDUCING POVERTY, AND RECENT FINANCIAL MANAGEMENT INITIATIVES

Approximately 25% of the world's population, some 1.5 billion people, live in poverty. It is infeasible that absolute poverty could be eliminated solely by income redistribution within countries or between wealthy and poor countries. Transfers from rich to poor countries even on a limited scale meet political resistance, and there is little evidence that income inequality in the third world has changed significantly over the last thirty years[i], though there is evidence of growing inequality in some first world countries and in the former Soviet Union countries. To eliminate poverty by 2050 without changes in income distribution would require per capita income in the third world to grow by about 3.5% per annum in real terms[ii]. The impact of income changes on the elimination of poverty can be enhanced by strategies that support income generation by poor people, reduce (or at least restrict increases in) income inequality, and transfer wealth from rich to poor countries.

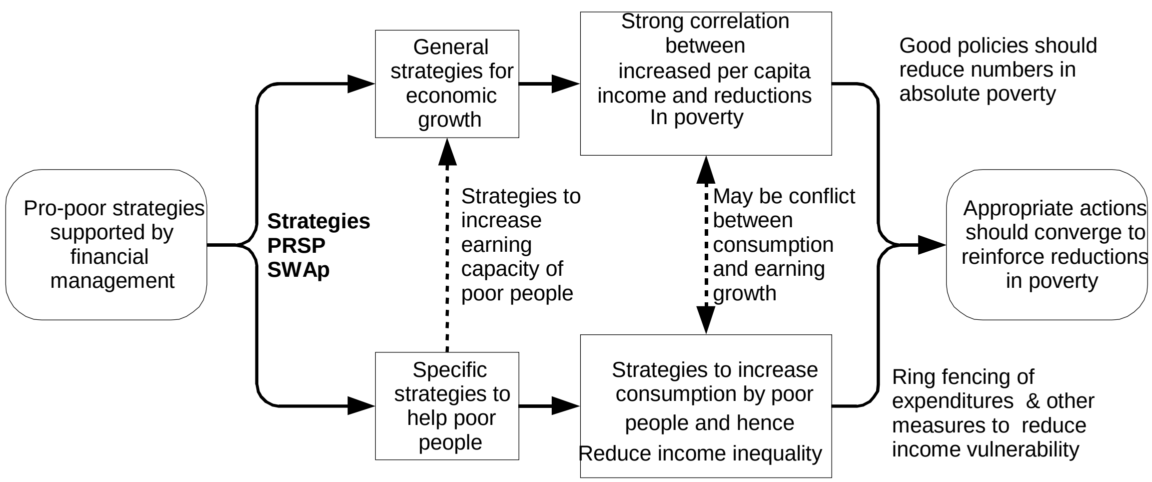
3 FINANCIAL MANAGEMENT REFORM, PRSPS AND SWAPS

Strategies to increase income generating capacity of poor people and strategies to enhance economic growth should be mutually reinforcing. However, there may be a conflict between growth strategies and strategies to increase consumption by poor people. In the latter cases choices may have to be made between short and long run benefits. Poverty Reduction Strategy Papers (PRSPs) seek to identify a balanced package of strategies to meet all of the above requirements. PRSPs lead to a policy matrix of required actions. These may enhance consumption by poor people, e.g. "Provide universal access to safe drinking water and to sanitary means of excreta disposal ….". Or they may enhance capacity of poor people to generate income, e.g. "Increase school enrolments by girls in the age range 11 to 13 from 30% to 70% …". Translation of policies into actions typically requires the directed expenditures of public funds, and the mechanism for achieving this is through budget allocations and budget execution. The requirement is for budget processes and systems that enable pro-poor policies to be implemented, accounting systems that enable expenditure to be tracked, and audit and accountability mechanisms that provide transparency.

An approach to integrating pro-poor strategies into allocations processes has been the Sector Wide Approaches (SWAps). Under SWAps all significant public funding for a sector supports a single sector policy and expenditure programme, under Government leadership, adopting common approaches across the sector, and progressing towards relying on Government procedures to disburse and account for all public expenditure, however funded.iii Claimed benefits of SWAps include a focus on the strategies and policies of government (fiscal discipline, allocation and efficiency); a focus on strengthening government institutions; the potential for simplification and harmonisation of aid procedures between Donors and with it the potential to increase and accelerate aid flows; and to enable decentralisation. There is as very little hard evidence of the extent to which the poor benefit from SWAps, and one study concludes "There is a mixed picture on the extent to which the poor are benefiting…"[iv]. However, there is evidence that joint reviews conducted as part of the SWAp analysis have sharpened the focus on poverty.

The expectation is that sound public financial management associated with initiatives like PRSPs and SWAps will support growth strategies, pro-poor strategies, and the making of rational choices between alternatives. The relationships are summarised in Exhibit 1: 1 below.

Exhibit 1: Linkages between pro-poor strategies



4 SPECIFIC LINKAGES BETWEEN PUBLIC FINANCIAL MANAGEMENT AND PRO-POOR STRATEGIES

Many target countries for HIPC, PRSP and SWAp initiatives have inadequate public financial management systems; such system inadequacies require addressing. Of the 22 countries that had reached the HIPC decision point by end-2000, 16 countries have identified needed improvements in PEM systems covering the broad categories of budget formulation, execution, and reporting, as completion-point triggers.[v] In a move to pro-poor strategies the drive for sound public financial management must be reinforced. Public financial management has a role in both pro-growth and consumption redistribution strategies. Improvements in public financial management are often a precondition for ensuring that Governments *can* budget for poverty reduction.[vi] The World Bank has summarised the goals of public financial management in the Public Expenditure Manual, and these are linked to pro-poor strategies below.

Exhibit 2: Goals of government financial management

Goal	**Linkage to pro-poor strategies**
Level 1 - fiscal management	Distributive impact of tax and non-tax revenue raising Impact of fiscal issues (risk, shortfalls, etc) on pro-poor strategy and income vulnerability
Level 2 - resource allocation	Fundamental to the concepts of pro-poor strategies is the ability to allocate resources in a directed manner through the budget process
Level 3 - value for money	With limited resources in poor countries, obtaining value for money - efficiency, effectiveness and economy - in expenditure is critical. Embraces the need to avoid leakages through corruption or theft
Transparency	Fundamental to an enabling environment - make effective participation feasible, minimise opportunities for leakage, enhance the democratic decision process
Accountability	

Implementing these goals requires an effective public financial management system that facilitates the development and implementation of budgets that are evenly balanced to meet the needs of the poor. In order to develop the pro-poor financial management system a number of issues need to be addressed:

Participation in the budget process

The budget organization and ability to allocate resources through the budget

Budget timeframe and comprehensiveness

Realism of the budget process and ability to translate budget decisions into actions

Performance targets and their linkage to budget allocations

Expenditure tracking and government accounting systems

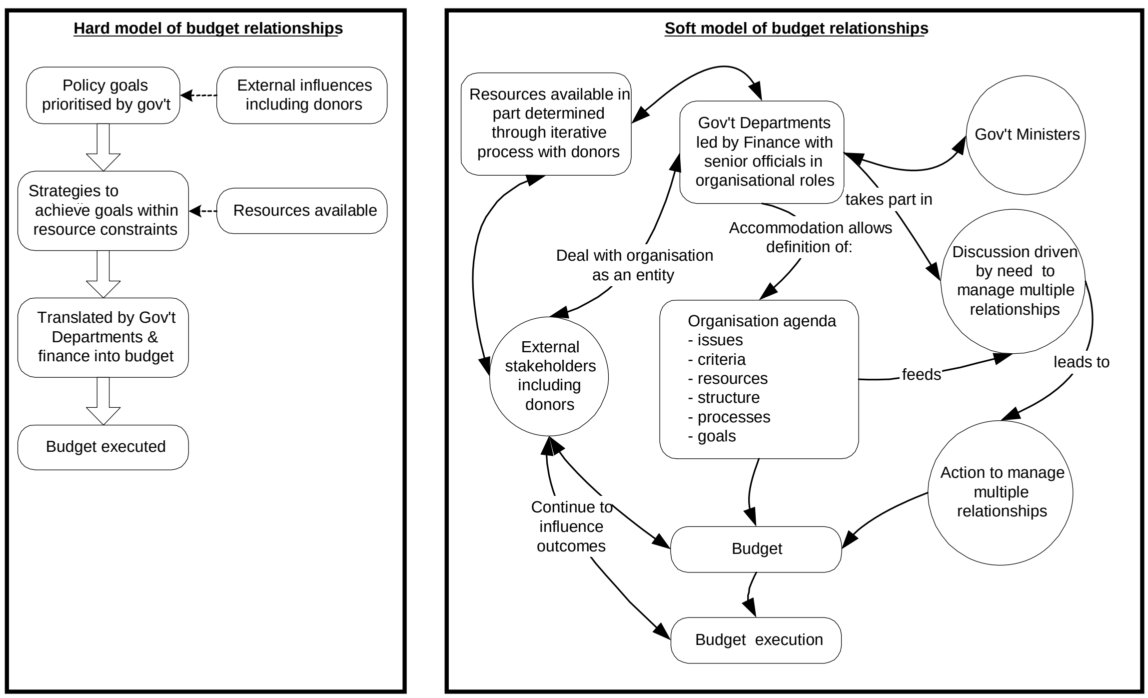
5 PARTICIPATION IN THE BUDGET PROCESS AND THE ASYMMETRY OF INFORMATION

It may seem strange to put participation first in an article on financial management, but an understanding of organisational relationships is fundamental to understanding how budgets are created and implemented, and the practical difficulties of implementing pro-poor strategies. Traditional "hard" organizational theory envisages the Government establishing its goals and priorities, and then using the budget to turn these into actions subject only to fiscal constraints. Creating a pro-poor budget requires governments to identify appropriate strategies before they can do this, and to then incorporate these into the process.

A "soft systems" approach[vii] recognizes that political process involves an organizational entity - the government Departments led for budget purposes by Finance - responding to a range of stakeholders and organizational pressure groups. Government Ministers, though theoretically able to dictate policy, rarely have such unfettered authority, agree amongst themselves, or have adequate information. Donors, powerful interest groups and other stakeholders also influence Government Departments. The concept of the asymmetry of information means that full information on the impact of decisions will not percolate to higher levels of government, and therefore broad policy decisions are made without a full understanding of their effect or how they will be implemented.

This "soft" but more realistic model of the budget process envisages a Department of Finance trying to manage the budget process to meet the needs of a range of stakeholders, and without detailed information on the outcomes that will result from resource allocation decisions. Within the milieu, poor people have traditionally had little influence and a very weak voice "… there is hardly any consultation with ordinary people …"[viii] One objective of pro-poor policies and their articulation through PRSPs and SWAps is to give the poor, or their representatives, a greater voice in the budget process. Without such participation, other stakeholders will reassert their dominance over the budget process. Examples cited in Zambia illustrate how such a process works in practice.[ix], and the alternative models are illustrated in 3 below.

Exhibit 3: Hard and soft models of budget process



In order to achieve effective participation by poor people in the budget process, transparency and accountability become not merely desirable, but essential. Departments of Finance, however, often minimize access to information to reduce their exposure to pressure groups, which disproportionately disadvantages poor people who will lack the informal information channels open to other more influential stakeholders. Poor people and their representatives need transparency to provide them with the information to challenge established pressure groups.

Two examples show how participation can work. In Rajasthan, India, an NGO, MKSS, has developed a system of social audit of government expenditures. This has served to identify the connection between wealth of the rich and the villagers' continuing poverty. In Porto Alegre, Brazil, participatory budgeting at the local level has served to demonstrate the conflicting demands when participation expands, but has also demonstrated the use of a weighting system to resolve such conflicts.[x] It is concluded that any pro-poor budge strategy must recognise the organisational complexity of the budget process, enable effective participation by poor people, and achieve accountability and transparency as fundamental to realisation of pro-poor strategies.

6 THE BUDGET ORGANIZATION AND ABILITY TO ALLOCATE RESOURCES THROUGH THE BUDGET

The Government budget is a legal instrument authorising the raising of revenues and the expenditure of public money. Budgets are organised first and foremost to achieve these national fiscal objectives. In almost all countries budgets are linked to an annual budget cycle. As a tool to allocate resources for pro-poor or other specific strategies budgets exhibit four limitations: (1) The classification of expenditures is not linked to strategies; (2) The annual timeframe, and particularly the lapsing of funds at the end of the year, are inappropriate for strategies that take several years to mature; (3) There is no guarantee that funds allocated in the budget will be spent as intended; and (4) Expenditures are not easily linked to performance indicators.

7 CLASSIFICATION OF EXPENDITURES

Traditional budget classification structures have followed the way in which expenditure is "voted" by the legislature, normally reflecting the department organisation structure. In addition, for expenditure control purposes budgets have been divided into economic categories, e.g. payroll, utility costs, capital expenditure, etc. This provides a matrix classification. Since Departmental organisations vary between countries, and titles often bear little resemblance to sectors, the IMF have sought to rationalise the organisational analysis by requiring all countries to provide statistics in accordance with a standard classification. In the latest edition of the IMF Government Financial Statistics Manual[xi] there are some 62 functional classifications. Incorporation of these into the classification system will often cut across Departmental boundaries, and in effect introduces a third analytic dimension.

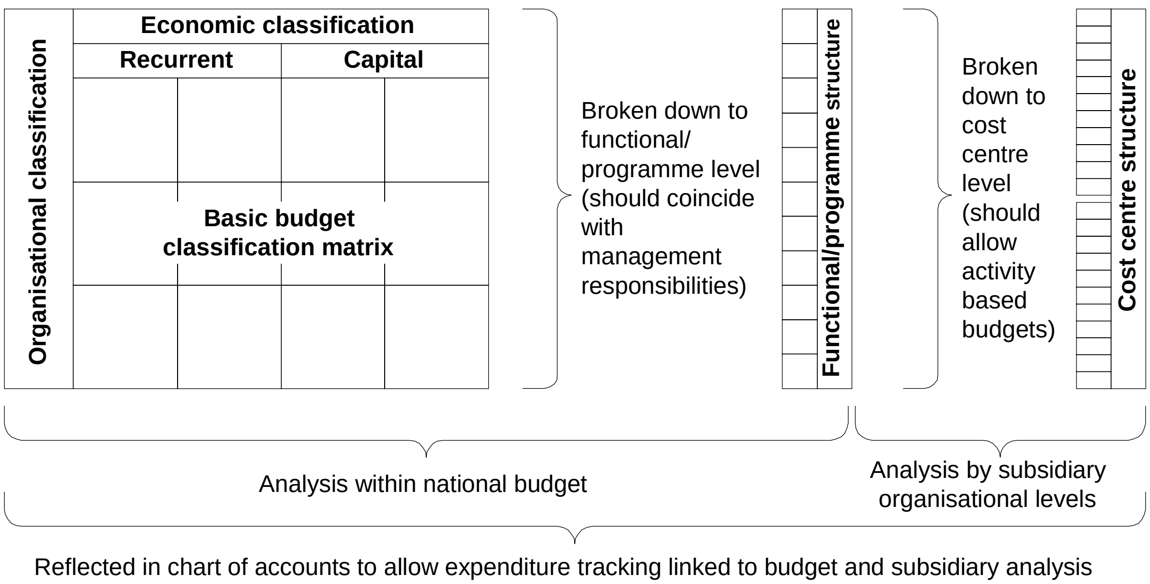
Nevertheless, analysis to the IMF GFS functional classification is still unlikely to be sufficient for allocating resources in accordance with PRSP strategies. For example the Zambia PRSP 2002 has as a health care priority "*Integrated Reproductive Health*"[xii]. This requires a programme structure below the level of the GFS functional classification. Yet in 25 HIPC countries surveyed by the IMF in 2001 only 9 had a functional classification available for two years earlier, and "classification by program is rare"[xiii]

Functional and programme classifications appear to meet the needs of a PRSP, but in fact they have some quite fundamental flaws as poverty strategy management tools: (1) Functional and programme classifications have no automatic link to management responsibility. In consequence expenditures may be analysed in a manner unrelated to management control; (2) The programme level of detail is still insufficient for detailed management control, the building of activity cost models or allocation to geographic locations. What is required is classification structure that breaks expenditure down to individual cost centers. This implies a level of decentralisation that clashes with the common model in which a central finance department controls allocations.

The conclusions may be summarised as follows: (1) Of necessity, governments must classify their budgets organisationally and by economic categories, but this alone is insufficient for management or poverty reduction strategies; (2) IMF GFS functional categories provide a more detailed and standardised classification of expenditures, but are unlikely to be sufficient to either manage expenditures or to be linked to government organisation structures; (3) Programme budgets can be linked to pro-poor and other strategies, but are only effective management tools if coincident with management responsibilities; and (4) In order to properly manage and track expenditures, cost centre analysis is essential, but the cost centre structure and detailed resource allocation should be driven by individual organisational units rather than by a Department of Finance.

Such a structure is feasible. In Nepal as part of the budget system, a facility has been established for the Budget to be enacted to functional level, and then individual Ministries authorise spending at the more than 3,000 cost centres across the country.[xiv] A model of this classification structure is provided in Exhibit 4 below.

Exhibit 4: A budget expenditure classification structure



As noted above, this model is perfectly feasible to implement in practice. Also, most accounting and ERP packages are geared towards costs centre accounting, and can handle the above analysis and use it to derive reports with different forms of aggregation. It will enable tracking of specific pro-poor strategies and can be linked to performance indicators (see below).

8 BUDGET TIMEFRAME AND MEDIUM TERM BUDGETS

The annual budget cycle is inadequate for strategic resource allocations. Problems are the fact that most strategies take more than one year to mature, the need for certainty of funding, and the problem of funds lapsing. Most pro-poor and development strategies take a number of years to implement and for their benefits to be realised. Capital projects often extend over many years, and the impact even longer to realise. These time frames are much longer than the budget cycle, and trying each year approve a slice of capital expenditure is technically difficult, and fails to manage the project over its life cycle. One of the most difficult problems is the lack of certainty of funding, since unspent funds lapse at the end of each year, yet the timing of expenditures may be difficult to predict and affect by many exogenous factors.

Segregation of budget expenditure into Recurrent and Development budgets was intended to address the problem, with different procedures for each budget, but in practice development budgets have become little more than vehicles for development projects, often including some recurrent expenditure, whilst recurrent budgets are often little more than budgets for government salaries. A recurrent/capital division is clearer and more readily defined, but does not in itself address the issue of the budget timeframe.

A medium term (3 to 5 years) budget framework (MTBF) does begin to address the issue, provide time for strategies to mature and some certainty of future funding. Whilst an even longer timeframe may be theoretically desirable, there is evidence that forecasts beyond three years rapidly lose reliability, and may detract from the relative certainly of a 3-5 year budget period.

Medium term budgets do offer a significantly enhanced framework for implementing pro-poor strategies, but to be effective certain conditions need to be met: (1) The processes for preparing the medium term and annual budgets must be integrated; (2) Medium term budgets must be legally recognised as providing a framework for annual budgets; (3) The issue of lapsing of funds must be addressed. In responding to donor pressure for medium term budgets, it is relatively easy for countries to append a medium term budget process after the annual budget is completed. Such an approach may provide useful analytic and forecasting information, but does not impact on the budget process itself. In Kenya, for example, there is a detailed medium term budget published after the annual budget, leading to a considerable volume of documentation. Yet this as proved ineffective at controlling off-budget expenditure, nor is the medium term budget is not an input to the annual budget process[xv]. Instead, the objective should be to fully integrate the annual and MTBF processes, so that the first year of the MTBF becomes the basis for the current years budget, and an extra year is added - a “rolling” approach, as adopted in Australia.

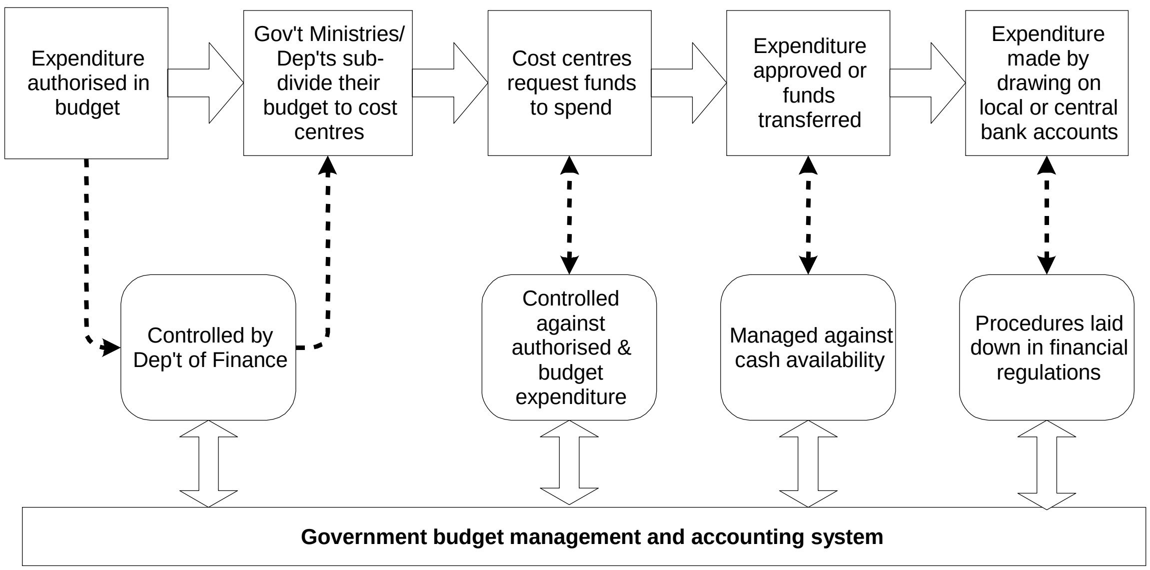
It follows from the above that there needs to be some legal status for the MTBF, so that it can be approved as part of the budget enactment process. Legal recognition forces clarification of the relationship between MTBF and annual budgets, and indicates a commitment to future spending plans. Such commitment and certainty of funding is essential for effective pro-poor strategies. Finally, the issue of lapsing of funds needs to be addressed within the MTBF context. The nature of government budget approval is that funds are voted for expenditure within a specified period of time, and if not spent “lapse”. This process, however, can very significantly distort government expenditure time profiles. For example, in Papua New Guinea, a high proportion of government expenditure takes place in the last two months of each financial year[xvi]. Because a legal MTBF authorises expenditure over a number of years, it is feasible to devise simplified approaches for transferring funds inter-temporarily between financial years. Again this can be very important for pro-poor expenditures, where the harvest cycle may be more important that the financial cycle.

9 REALISM OF THE BUDGET PROCESS AND ABILITY TO TRANSLATE BUDGET DECISIONS INTO ACTIONS

There are a range of reasons why expenditures voted in the budget may not actually be expended. A common reason is that the budget vote may be a political device, for example in Nepal projects are regularly voted in the budget hen “suspended” - the projects are there to satisfy political pressures and there is not real intention of their implementation. Another common problem is that cash is simply not available for the voted expenditures - officials who manage cash releases make the "real" budget allocations. Further complicating matters is the general experience in which a complex bureaucratic process for the incurring of expenditure provides opportunity for pressure by interest groups, corruption, theft or simply inability to manage the process to result in funds not being spent as intended.

It is certain that the expenditure procedures in most poor countries are excessively bureaucratic, and that controls originally established to avoid corruption often end up by increasing the opportunities for such corruption, as well as creating inefficiency and delays in expenditures. There is no universal model of the processes, and even in English speaking countries the terms used have different meanings. Exhibit 5 below provides a simplified generic model, synthesised from several different countries.

Exhibit 5: Simplified generic model of expenditure processes



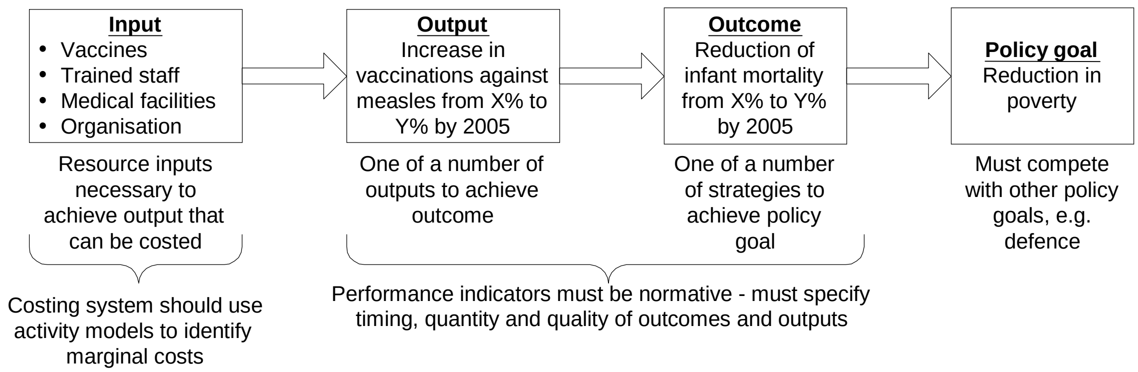
If the budget is realistic in terms of fund availability and expenditure needs, and there are efficient bureaucratic and accounting systems, then the above procedures should work smoothly. However, as already indicated, this will not be the case in a poor country - the nature of underdevelopment will involve governmental inefficiencies. It is our experience that macro level designs rarely take account of these detailed issues, yet problems at this level are often a cause of reform strategies failing. There is often significant resistance to the reform of expenditure processes. Complex bureaucratic processes create employment, provide opportunities for corruption and enable interest groups within the bureaucracy to manipulate expenditure patterns. Yet unless these issues are addressed, pro-poor strategies will always achieve less than their full potential.

10 PERFORMANCE TARGETS AND THEIR LINKAGE TO BUDGET ALLOCATIONS

Performance management represents an attempt to shift the focus of public sector managers (and politicians) from controlling expenditure to delivering outcomes. A specific outcome would be the reduction of poverty. However, as indicated above, poverty can only be evaluated through a series of measures, e.g. the UN Human Poverty Index measures, and a range of variables influences each of these measures.

Therefore, to implement performance management as a practical system, outputs must be developed that can act as surrogate measures for outcomes. The linkage is illustrated in Exhibit 6 below.

Exhibit 6: Outcomes and outputs



The conclusion is that there are two surrogate groups of measures of the impact of strategies on outcomes: (1) Input measures - can be achieved by tracking expenditures, dealt with separately below; (2) Output measures - from the analysis above output measures must be linked to both input (expenditure) and outcomes. This paper is not primarily concerned with the development of output targets, but six key requirements are set out below.

1. Output targets must be linked with the budget process so that there is a direct link between expenditure and performance delivery. In Lesotho, an approach has been developed for the health sector where any increased expenditure must be justified in terms of change in anticipated outputs. As set of performance indicators unrelated to the budget process is unlikely to be useful.
2. Outcomes and outputs need to be organised in hierarchy, so that one outcome is represented y a series of outputs. The Logical Framework approach is useful tool for achieving this relationship.
3. Output targets must be capable of normative measurement of changes in terms of both quality and quantity within a specified period of time. This does not preclude judgement evaluations, but requires that they are made specific.
4. Targets need to be established participatively involving both those who execute policies and potential beneficiaries. In the case of pro-poor strategies this means involving poor people or their representatives. Participatory target setting ensures commitment and also relevance of output targets.
5. A transparent system of expenditure and performance reporting linked to original targets and individual responsibility, and subject to independent audit, review and accountability.
6. Finally, there need to be rewards for good performance and sanctions for poor performance. A performance management system that is ignored in staff evaluations, or where public servants are not made accountable, is unlikely to be effective. The danger is that managers alter their behaviour to do well

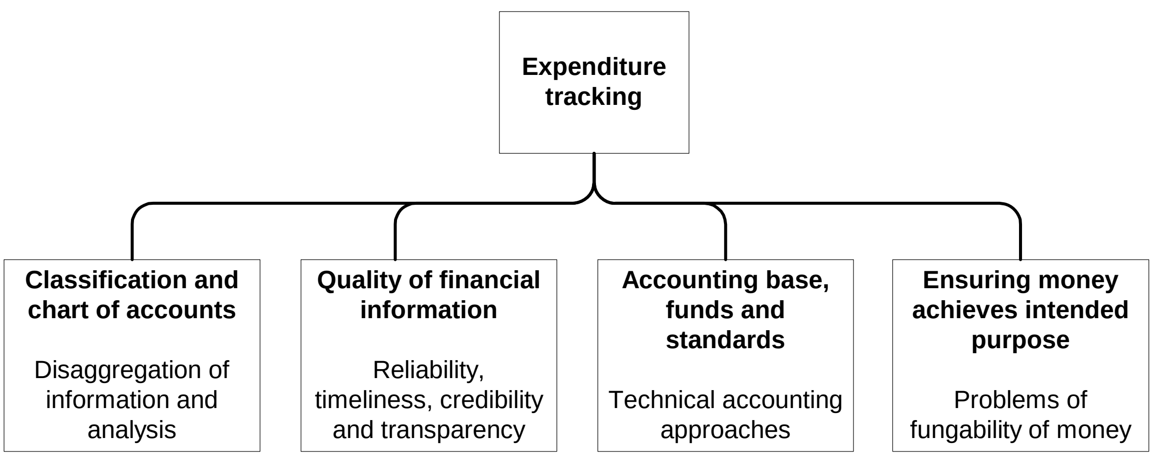
exclusively in terms of their performance targets, which may be sub-optimal from the perspective of the nation as a whole.[xvii]

11 EXPENDITURE TRACKING OF PRO-POOR EXPENDITURES

It follows from the model in Exhibit 6 above that the first step in managing pro-poor strategies is to ensure that money is actually spent as allocated in the budget. There is a clear but asymmetric relationship between expenditures and outcomes - expenditure is a necessary but not sufficient condition for achieving a given outcome. There is no known research on the correlation between expenditures and outcomes as compared to that between outputs and outcomes. This area is referred to as expenditure tracking, but in fact embraces a number of issues.

There is evidence that even where funds are allocated in a pro-poor manner in the budget, that intention is not followed through to actual expenditure[xviii]. Furthermore, few accounting systems are able to track such expenditures and report on them in a meaningful manner. Yet it is clear that if a pro-poor budget is to achieve its objectives, it is essential both that expenditure takes place as intended, and that such expenditure can be followed through. This requires expenditure tracking and publicly available reports that are both reliable and timely. The analysis above has already indicated why this may not be the case. For clarity the issues are put into a framework in Exhibit 7 below, and then addressed separately in the sub-sections that follow.

Exhibit 7: Expenditure tracking issues framework



In considering these, it is useful to see how the IMF evaluation criteria for expenditure tracking asset out in Exhibit 8 below, fit into the above model. This is indicated by the third column, but in relating these two frameworks it must be recognised that the IMF criteria go beyond expenditure tracking to consider in some instances the whole of government financial management.

Exhibit 8: Crosswalk of IMF criteria to framework for expenditure tracking

Budget Management	**Benchmark Description**	**Linkage to framework of expenditure tracking issues**
Comprehensiveness		

Budget Management	**Benchmark Description**	**Linkage to framework of expenditure tracking issues**
1. Composition of the budget entity	"Close-fit or better" to GFS definition of general government	Accounting base, funds and standards
2. Limitations to use of off-budget transactions	Extra (or off) budget expenditure is not substantial	
3. Reliability of budget as guide to outturn	Level and composition of outturn is "quite close" to budget	Ensuring money achieves intended purpose
4. Data on donor financing	Both capital and current donor funded expenditures included	Accounting base, funds and standards
Classification		
5. Classification of budget transactions	Functional and/or program information provided	Classification and chart of accounts
6. Identification of poverty-reducing expenditure (e.g., a virtual poverty fund)	Identified through use of classification system	
Projection		
7. Quality of multi-year expenditure projections	Projections are integrated into budget formulation	See above on budget issues
Internal Control		
8. Level of payment arrears	Low-level of arrears accumulated	Accounting base, funds and standards
9. Quality of internal audit	Internal audit function (whether effective or not)	Quality of financial information
10. Use of tracking surveys	Tracking used on regular basis	Classification and chart of accounts
Reconciliation		
11. Quality of fiscal/banking data reconciliation	Reconciliation of fiscal and monetary data carried out on routine basis	Quality of financial information
Reporting		
12. Timeliness of internal budget reports	Monthly expenditure reports provided within four weeks of end of month	Quality of financial information
13. Classification used for budget tracking	Timely functional reporting derived from classification system	Classification and chart of accounts
Final Audited Accounts		
14. Timeliness of accounts closure	Accounts closed within two months of year end	Quality of financial information
15. Timeliness of final audited accounts	Audited accounts presented to legislature within one year	

The analysis below used the expenditure tracking framework, but uses the cross walk to link this back to the IMF criteria.

11.1 Classification and chart of accounts

Classification issues have already been addressed above. The IMF framework requires a functional and programme structure, which fits with the model of budget classification in Exhibit 4 above, but the latter goes further and looks for disaggregation to the level of cost centres. The budget classification must be followed through into the chart of accounts, which will in addition include asset and liability accounts depending on the accounting base adopted. Linked to the issue of classification is the ability to analyse information in a manner that is useful for linking expenditure to outcomes. This means moving away from traditional unit costs absorbing all overheads, and instead developing models based on activity costing. Activity costing is much closer to the economic concept of marginal cost than is the traditional accounting average unit cost. As such activity based costing provides a better model for tracking expenditures. If there is a sufficiently detailed classification structure then the need for separate expenditure tracking surveys should be minimised, but such surveys are always likely to be required to relate expenditure to detailed poverty related strategies.

11.2 Quality of financial information

There are a number of facets to quality of financial information:

Reliable - more than accuracy, information must be reliable for purpose intended

Timely - information must be available in time to be useful for decisions

Credible - information must be believed as reliable by users

Transparent - information must be made available in an appropriate format to users.

Reliability requires accounting systems, processes, trained staff and internal controls so as to ensure transaction data is correctly recorded and classified. Controls should include reconciliations with external sources, especially with bank records. Internal controls should include comparison with budgets and internal audit. Timeliness is relative concept. Information is required for decisions and post-event monitoring. It must always be available in time to influence future decisions. For many pro-poor strategies, information will be required in "real-time" during the financial year, so that resources can be properly managed. For post-event monitoring, there is a longer timeframe, but information is still required whilst events are fresh in people's minds, and the protagonists are still in post. Credibility requires and external verification through and independent audit. The audit must be perceived to be independent, be of high quality, and report on issues that are relevant to poor people, for example the fact that money intended for primary health care has been diverted to pay for sophisticated equipment in hospitals in the capital city. Finally, transparency requires that information should be made available to poor people or their representatives quickly, in an appropriate format, and in a manner that makes analysis and interpretation feasible.

11.3 Accounting base, funds and standards

There can be no doubt that an accrual accounting base provides a more meaningful and logically consistent base for tracking expenditure. It will, for example, identify unpaid bills, other liabilities, and assets and relate expenditures to appropriate accounting periods. However, it is equally certain that most poor countries will not have the resources to adopt full accrual accounting for some time into the future. It is therefore necessary to adapt a cash basis of accounting so that it can provide the required information for tracking pro-poor expenditure. There are a number of approaches. A modified accrual basis can provide information on unpaid bills and better manage intertemporal adjustments. The adoption of International Public Sector Accounting Standards (IPSASs[xix]) provides a framework for measuring and presenting accounting information, including the format of published financial statements.

A related issue is the definition of the government entity, and then ensuring that the government budget comprehensively includes all government resource flows, and that these are all reflected through the accounting system. The IMF GFS Manual provides a definition of the government entity. However, very often some resource flows, e.g. commodity aid, direct payments for services, are not captured in the budget and hence the budget is an incomplete picture of resources allocated so sectors. Even when captured in the budget, the flows may not be reflected through the accounting system, for example because of the use of trust bank accounts or direct donor disbursements. All resource flows do need to be captured to provide comprehensive expenditure tracking. A fund approach may be used to identify pro-poor expenditure, ash as been adopted in Uganda with the Poverty Action Fund, or in Tanzania with the Multilateral Debt Fund. Funds can be a useful device, but they have very definite limitations because (i) funds do not necessarily capture additional spending on poverty reduction, and (ii) separate funds do not provide assurance that sufficient funds have been allocated for poverty reduction; (iii) management of funds diverts resources.

11.4 Ensuring money achieves intended purpose

The problem of resources not reaching the intended point of service delivery has been repeatedly experienced – especially where decentralisation of services has enabled local Government to access resources.[xx] There are various approaches to ensuring money reaches its intended target, for example hypothecation, earmarking, and ring fencing.

Under hypothecation funs generated from a specific source, e.g. a road cost recovery scheme using tolls, are used in relation to the same activity, e.g. road maintenance. Hypothecation is particularly appropriate for cost recovery funds and often happens informally, e.g. hospital charges being kept by the hospital. Earmarking describes the situation when funds are provided, typically buy an external donor, and are earmarked for a particular activity or purpose. The earmarking may be built into the loan or grant conditionality, and can often be enforced through a staged or tranche release. Ring fencing applies where a budget allocation for a particular purpose, e.g. primary education, is protected against cuts through a notional ring fence. The effectiveness f ring fencing depends on the robustness of the government in ensuring it is observed.

Each of the above approaches is a tool to ensure funds are used for the purpose intended, and are particularly important in protecting social and pro-poor expenditure. However, even if successful the problem of fungability remains. Money is *fungible* when a Government offsets donor spending on a particular purpose by reducing its own expenditure on the same purpose. For example, donor funding earmarked to health will not increase total health spending if Government reduces its own health spending, and uses the funds thus released for some other purpose. Fungability means that countries are able to expend money in accordance with government priorities even though aid funds may be provided for some different set of priorities.

If donors disagree with Government spending priorities, they can try to influence them through policy dialogue, through conditionality, or by earmarking their aid. Depending on the stage in the budget cycle at which earmarking takes place and Government reactions to it, it may be capable of changing allocations between or within sectors, or the extent to which aspects of the finally approved budget are actually executed. It requires strong assumptions regarding the efficiency of the budget process and the relative power of the finance ministry before donor earmarking is rendered entirely impotent.[xxi]

11.5 Conclusions on expenditure tracking

The analysis above indicates that expenditure tracking can become complex, and requires a strong accounting system to be effective. It is fundamental that such as system must be an integral part of the budget/accounting system, not a "bolted on" extra system. Making the poverty expenditure tracking integral to accounting has clear advantages: costs are minimised, the credibility of the data is improved, and sustainability is made feasible.

12 CHANGING GOVERNMENT FINANCIAL MANAGEMENT TO A PRO-POOR ORIENTATION

The analysis above indicates some of the extensive range of actions and possibilities for a pro-poor orientation in financial management. Without such an orientation, many of the strategies will be difficult, if not impossible, to implement successfully. Experience is that it is feasible to implement technical changes in systems, but much harder to implement real changes in behavior. *This appears to reflect general experience: "Improved capacity in budget formulation may be less difficult to achieve in the short term, but it may prove ineffective unless accompanied by reforms in budget execution and reporting that are more difficult to achieve."*[xxii]

Much technical work, usually with donor support, is being undertaken to establish medium term and/or performance budget systems, to implement so-called "integrated financial management systems" (usually accounting systems). Many of these activities will yield technically sound solutions, and there is no doubt that this will provide an improved information infrastructure. However, in itself this will not result in pro-poor financial management, because the latter requires all of the changes identified above.

In summary a pro-poor financial management structure requires the features identified in Exhibit 9 below to be functioning.

Exhibit 9: Summary of features of pro-poor financial management

Major area	Required features
Participation	Recognition of organisational complexity of budget processes Enable effective participation by poor people Achieve accountability and transparency
Budget organisation	Classification by functions and programmes Preferably a sufficient level of disaggregation to identify cost centres controlled at a decentralised level
Budget timeframe	A medium term budge timeframe integrated with the annual budget process Legal status of medium term budget Procedures to avoid lapsing of budget allocations for pro-poor expenditure
Realistic budget	Resources realistically available to fund budget allocations Payment processes that efficiently and expeditiously lead to disbursement of funds without excessive transaction costs
Performance management	Output targets linked to budget Hierarchy of outcomes and outputs Outputs capable of normative measurement Participation in setting outputs Transparent performance reporting subject to audit

Major area	Required features
Expenditure tracking	Classification followed through into chart of accounts and reporting system Quality financial information - reliable, timely, credible and transparent Appropriate accounting base, cost models and use of fund accounting Strategies to ensure money reaches its target

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[x] Both examples from "Budgeting as if people mattered" NDP, 2000

xi "A Manual on Government Finance Statistics" (revised) IMF 2001

[xii] Zambia PRSP 2002, published on the IMF web site

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[xiv] Nepal Financial Management Project, 1994-2002, DFID, internal papers

[xv] This is based on the writer's own study of the Kenyan system, and is a valid statement as at 1999

[xvi] "Papua New Guinea Strategic Framework for Financial Management Improvement" Department of Finance 2001

[xvii] An example is provided by health sector performance targets in the UK. One target is to reduce the numbers on hospital waiting lists. Hospital managers have reacted rationally to this target by (i) restricting entry to waiting lists, and (ii) performing as many quick treatments as possible to remove the maximum number from the waiting lists with minimum resource consumption!

[xviii] In 1998 a survey in Uganda found that less than 1/3 of non-salary expenditure for primary schools actually reached the target schools

[xix] As published by the Public Sector Committee of the International Federation of Accountants (IFAC)

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