CHAPTER SEVEN

Budgeting and Expenditure Management in Local Government

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Roles of financial planning and budgeting

There are three key roles for financial planning and budgeting in local government. Firstly, policy-making involves setting expenditure priorities in line with policies and plans, and then allocating the available resources in line with those priorities. The policy-making role also involves choices about local tax rates, together with tariffs for fees and charges, so as to generate sufficient resources to meet the planned expenditure. Secondly, financial planning can be used as a management tool, to provide financial information for the managers of services and programmes, to ensure that expenditure programmes deliver value for money, and to monitor revenue and expenditure performance during the year. Thirdly, it can be a mechanism of control, through the authorisation of expenditures, prevention of abuse and fraud, and ensuring solvency by preventing fiscal deficits.

Plans and budgets also serve as instruments for citizen participation and local government accountability, enabling citizens and civil society to engage with local decision-makers about the use of available resources, and subsequently to hold the local government to account for their actual use.

Annual budgets should reflect longer-term development plans and policies, as well as any medium-term financial and expenditure plans, such as a medium-term expenditure framework (MTEF), which should provide the framework for the annual budget. The longer the time scale, the broader the plan needs to be because of the degree of uncertainty. Thus, long- and medium-term plans need to identify broad strategies, whereas annual budgets need to be detailed for purposes of financial control.

Plans and budgets seek to identify:

- Objectives and targets for revenue and expenditure programmes
- Future expenditure needs
- Future resource availability
- Changes in circumstances which will affect needs and resources

- Constraints and opportunities
- Strategies for achieving objectives within the constraints
- Priorities between alternative uses of resources.

Recurrent and capital budgets

It is normal to distinguish between recurrent and capital budgets (the former is sometimes referred to as the revenue budget). The recurrent budget covers all expenditures for ongoing activities, including wages and salaries, operating costs, maintenance costs and transfer payments (e.g. welfare payments and transfers to lower levels). It also includes debt servicing (although the repayment of the principal element of debt servicing may be treated separately in some budgeting systems).

Since the benefits of recurrent expenditure are used up during the course of the year, it should be financed from current income: taxes, charges and recurrent grants, and not from borrowing or asset sales.

Capital expenditure involves the creation or acquisition of new assets which last for more than one year ('lumpiness'), which can be financed from capital receipts (borrowing, asset sales or capital grants), as well as from recurrent income. However, the distinction is not always clear: small items which last for more than one year (e.g. books) are usually classified as recurrent.

Some countries adopt different definitions, e.g. plan and non-plan in India, routine and development in Indonesia. These distinctions may have an economic justification (consumption versus investment), but they may have distorting effects (failure to spend money on maintenance means that 'development' expenditure has to be incurred to rehabilitate the asset). It may also blur the distinction about the appropriate way to finance the expenditure.

It is critically important that capital financing (borrowing or asset sales) is not used to finance recurrent expenditure, since that is unsustainable. In some systems (e.g. in some central and eastern European countries), the absence of separate capital budgets has meant that when capital assets (e.g. local government-owned property) were sold, the receipts were used up on current expenditure. However, too great a separation between capital and recurrent budgets can create other problems. When planning the financial requirements of a service, it is necessary to consider both recurrent and capital expenditures together, since effective and efficient provision of a service requires an appropriate combination of capital and recurrent spending.

The sub-national government budget preparation process

The budget preparation process usually occupies most of the year preceding the budget. It involves a number of stages.

a) *Reviewing the context and planning framework*

This should take account of:

- National, regional and local long- and medium-term development plans, policies and priorities; the annual budget should be seen as the mechanism for implementing such plans and strategies by allocating resources to them;
- The medium-term expenditure framework, which determines the parameters for the annual budget – as such, the budget represents the first year of a three-year rolling plan and the annual budgeting process will be largely about fleshing out the details;
- A review of actual performance of revenues and expenditures during the current and previous years, against the budgets for those years;
- The opportunities for citizens to participate in identifying the needs and priorities of the locality, and whether that process takes account of different interests, for example those of poor and marginalised groups, rather than reflecting only the views of the vociferous and well connected.

b) *Revenue forecasting*

This should not be just trend extrapolation, but should be a realistic assessment of the previous year's actual revenue performance and the factors that may affect revenues in the coming year, including exogenous factors which may affect revenue (e.g. changes in the local or national economy and changes in government policy which may affect local revenues). It should also take account of the scope for increasing revenue collection performance (increased effectiveness – but this needs to be realistic, so as to avoid revenue shortfalls during the year), and for revising tax and charge rates (especially those fixed in money terms) in line with inflation, and projecting the impact on the revenues of higher tax rates.

c) *Estimating expenditure requirements*

Recurrent expenditure estimates should:

- Be based on current commitments (i.e. the continuing costs of current services);
- Adjusted for inflation (this is usually best handled centrally by the finance department on a consistent basis for the whole budget, with spending departments preparing proposals at constant prices);
- Identify potential cost savings from greater efficiency or alternative ways of delivering services;
- Incorporate new commitments (recurrent cost implications of new commitments, e.g. operations and maintenance, and the debt-servicing implications of capital developments; effects of changes in national legislation or requirements; effects of approved changes in policy);

- Add in costs of proposed improvements to service provision.

It is important that estimates prepared by departments within the local government should be based on adequate guidance in advance from the municipal finance department about resource limits and policy priorities. This enables those managing the services to plan realistically within the resources available. In the absence of such guidance, spending departments are likely to bid high ('pad their bids') in the expectations of cuts, obliging the central finance department to make arbitrary decisions about cuts in budget proposals later in the process. However, this does require an appropriate mechanism for making broad resource allocations between departments or sectors. These are strategic choices which need to be made by elected representatives through a proper policy process based on agreed objectives and strategies.

Capital expenditure requirements will include previously agreed projects and proposed additional projects. Ideally, all projects should be subject to proper project (cost benefit) appraisal as part of the planning process, and future recurrent cost implications should be identified.

d) *Balancing the budget*

Invariably, expenditure needs exceed available revenue. Difficult choices have to be made. The options are:

- Increasing revenue, by raising tax or charge rates (but forecasted revenues need to be realistic, since unrealistic forecasts can lead to unplanned budget deficits or unplanned expenditure cuts during the year);
- Cutting expenditures;
- Drawing down reserves – if they are available;
- Budgeting for a deficit – something which no system of decentralised government finance allows.

Balancing the budget is essentially a political process. Although the municipal finance department may manage the process, ultimately decisions need to be taken by elected representatives, since these are strategic choices. The process needs to be as open and transparent as possible, and it must be guided by agreed policies and strategies of the elected council.

e) *Formal approval of the budget*

Approval must be given before the beginning of the financial year if budgetary control is to be effective. As well as approval by the elected council of the local government, the central (or state/provincial) government may have to give its approval. Delays in approval undermine the budget as a tool of expenditure management.

Some issues in local government budgeting

Input versus output budgets

Most conventional budgets are prepared in input terms: line items for wages/salaries, materials, transport, etc. Such budgets are useful for controlling expenditure, but give no indication of output, and nothing against which performance can be judged.

Ideally, budgets should be based around expenditure programmes with clear objectives, service standards, outputs and performance targets. Programme outputs can then be linked to the input costs in line-item terms needed to achieve the outputs. However, outputs and performance targets may be difficult both to specify and to measure. PPBS (programme performance budgeting system) is the classic form of programme budgeting, but is generally regarded as too complex and elaborate. Nevertheless, some attempt to specify outputs and performance targets, and to relate inputs to outputs, is essential if resources are to be better used. Without an indication of outputs, the only measure of performance is whether the money is spent, rather than what has been achieved.

Incremental budgeting

Most conventional budgets are incremental: planned expenditures are based on the previous year's expenditures plus an allowance for inflation or service improvements. Such budgeting is easy to do and offers relatively stability. However, it never challenges whether the activity is really necessary, or whether it could be carried out in other more efficient ways.

Bean and Hussey (1998) have summarised the advantages and disadvantages of incremental budgeting:

Advantages	Disadvantages
• Simple • Quick • Accurate if little change in activity	• Historic • No account taken of necessary future changes • Assumes the base is accurate • Compounds historic errors

Zero-based budgeting

Zero-based budgeting (ZBB) is one alternative to incremental budgeting, but is generally regarded as over-elaborate and unrealistic in most situations. However, selective use of ZBB can be valuable, for example, taking a particular service where there may be large inefficiencies and specifying from scratch what is required to achieve the output objectives and the costs of achieving these outputs. Contract specification for contracted-out (or out-sourced) services is a comparable process to ZBB, since it requires outputs and performance to be clearly specified in advance.

Some of the advantages and disadvantages of ZBB are shown in the box below (Bean and Hussey, 1998).

Advantages	Disadvantages
• Proactive • Realistic and accurate • Links into business plans	• Time-consuming • Requires clear objectives • Many organisations do not have a zero base, as they have to work with the staff, buildings and resources they inherit from year to year

Realistic revenue forecasts

The tendency of municipal governments in some countries is to inflate revenue forecasts to fit the projected level of expenditure, thereby pretending to show a balanced budget. This can be highly damaging, since actual revenue collection will fall well short of the forecast, with the result that the local government will run out of money during the year and arbitrary cuts will have to be made. This undermines the legitimacy and accountability of the budget process, and puts power into the hands of a few people (e.g. the mayor or the finance director) to make arbitrary allocation decisions during the year (Devas, 2003).

Unintended commitments

It is important to avoid unintended commitments. These can arise where approval is given to make a start on a major capital project without taking adequate account of the capital and recurrent cost implications in future years. Once the full costs become apparent, it may be politically difficult to abandon the project. This strategy is often used by project managers to establish incremental commitments to projects.

Consolidated budgets

Proper choices about resource use and transparency of decision-making require that all resources are treated together in one budget. While there may be separate accounts for specific services, these should all be brought together in one consolidated budget. The non-transparent nature of 'extra-budgetary' accounts and special funds provides scope for corruption and clientelistic decision-making.

Participatory budgeting

In Brazil, municipal governments have experimented with participatory budgeting (PB). Under PB, local communities are able to consider expenditure priorities affecting their neighbourhood (Souza, 2001). These are fed through into the municipal budget. Although the range of choice is often quite limited (city governments still exert tight control over the process), it has resulted in some redirection of expenditure towards the poor, wider participation of previously excluded groups and greater transparency over budgetary decisions.

The model has been emulated by local governments in a number of countries. There are also other ways in which greater participation in budgetary choices can occur:

- Giving local elected councillors a small budget for local priorities identified through a participatory process (although this tends to reinforce the clientelistic relationship of councillors with their electorate, as well as potentially giving an unfair electoral advantage to the incumbent);
- Giving 'area committees' of the elected council some spending powers in relation to their area;
- Establishing lower levels of elected local governance below the municipality, each with their own resources and budgets (Devas, 2003).

Expenditure management

a) *Financial procedures*

Expenditure management procedures need to define rules about authorising orders and payments, checking bills and recording payments. They must also include a method for approving virements, also known as re-appropriations (that is, the ability to move resources between budget heads).

Virements allow a degree of flexibility to deal with unforeseen or changed circumstances. A balance is required between the need for flexibility and the need for control – if there is too much flexibility, the budget does not serve the purpose of determining what happens.

b) *Revised or supplementary budgets*

Unforeseen or changed circumstances can also be handled by revised or supplementary budgets during the course of the year, but these undermine the credibility of the original budget. Frequent revisions make nonsense of the budgeting process, and revised budgets may be subject to less rigorous scrutiny than the original budget, raising issues about political choices and transparency. There is also the problem of where additional resources come from, if they are needed. If budgets are revised so that they can allocate surplus revenue, it might be better to retain the surpluses and allocate them through the proper budgeting process in the following year.

c) *Financial information system to monitor budget implementation*

There is a need for an effective financial information system to provide programme managers with timely financial information and to provide finance staff with information on the progress of the budget, including providing early warning of problems such as over- or under-expenditure or of shortfalls in revenue. Such information needs to be provided in a timely manner and in a format which makes identification of problems easy. Computerisation can help, providing systems are properly designed.

d) *Final accounts, auditing and accountability*

Final accounts need to be produced on time, say within six months of the end of the financial year, and submitted to the elected council. They should be audited by an independent external auditor (usually appointed by central government), and the auditor's report should be submitted to the elected council. In addition, there should be systems of internal audit, concerned with ensuring that systems are secure and prevent fraud. Both internal and external audit should be concerned not just with probity but also with effectiveness (achieving objectives or targets), efficiency (costs of services) and value for money. Information on budgets, accounts and audit reports should be made available to the public in ways that can be easily understood, as a means of holding the local government to account. (See chapter 8 for more detail on accounting and auditing.)

e) *Decentralised financial management to cost or budget centres*

These days, it is common for at least some financial management responsibilities to be decentralised to service managers within the local government – whether departmental heads or lower level managers who are responsible for particular services. The units to which financial management responsibility is decentralised are usually called cost centres or budget centres (or profit centres if they are net revenue generators). In the UK, a prime example is the decentralisation of financial management to school governors. Heads of local government contractor units also have to have a high degree of decentralised financial responsibility if they are to compete with private sector contractors in competitive tenders.

Decentralised financial management requires the manager to deliver specified service levels and performance within an approved budget. It has the advantages of encouraging service managers to:

- Plan so as to make the best use of available resources, rather than 'padding' their budget submissions for others (e.g. the central finance office) to cut;
- Use available resources most efficiently – efficiency improvements are rewarded by

being allowed to retain some or all of the savings within the budget centre to use to improve the service or reward staff, rather than being penalised by having to return any efficiency savings to the Treasury at year end;

- Collect all the revenue due for the service, since increased revenue means more resources available for the service.

However, decentralised financial management requires a proper system for deciding on the initial allocation of resources to each service, and proper specification of output or service levels and performance targets. There must also be systems of monitoring performance against targets, so as to hold service managers accountable, and financial controls to prevent misuse of resources. Service managers need skills in financial management, although they can be assisted by specialist finance people. The success of decentralised management also depends on an 'internal market', so that cost centres can trade with each other, e.g. buy services from one another (and perhaps from an external agency).

f) *Cash-limited financial management*

Where financial pressures are severe, and/or revenues are difficult to forecast, a system of cash-limited budgeting may be introduced. Under such a system, the finance department releases only the money that is received in the previous month, even if it is less than what is in the budget. This ensures that a deficit is not incurred.

While, under certain circumstances, cash-limited budgeting may be necessary, it tends to negate the purposes of the budget process as a means of managing expenditures in a stable and consistent manner, and can prevent the achievement of other strategic objectives. A better approach is to base budgets on more conservative and realistic revenue forecasts, and then adhere to those budgets. If actual revenues prove to be better than forecast, the surpluses can be added to reserves for use in subsequent years. However, such prudence is often difficult to achieve when both local politicians and officials demand greatly increased expenditure.

Financial management and the control of corruption

Decentralisation potentially puts more public resources at risk, in the sense that more resources are handled at locations remote from direct central controls, with more people having an influence on how the resources are used. Therefore, decentralisation may disperse corruption more widely, although it may not increase the overall level of corruption – indeed, it may help to curb it through greater accountability. Empirical evidence on the relationship between decentralisation and corruption is very mixed: for a review of the evidence from the various studies (Fjeldstad, 2004).

Nevertheless, achievement of the Millennium Development Goals requires services to be delivered throughout the country, and this requires finances to be managed in a decentralised manner, whether through local agencies of the central state or through devolved local governments. Therefore, whatever the particular mechanisms of service delivery at the local level, attention needs to be paid to financial management systems at the local level, and the capacity of both local citizens and central government to monitor resource use locally. This will involve developing secure revenue collection arrangements to prevent loss, collusion and fraud; record-keeping and accounting systems that inhibit fraud and provide automatic cross-checks; and public access to information about resource availability and use, to promote greater accountability to citizens. It will also require effective and transparent procurement and tendering arrangements, and effective auditing systems, including the development of national level, external audit capability, and systems that ensure that local governments act upon the results of external audits.

Given limited financial management capacity at the local level, this is quite a tall order, and there is no doubt that the lack of financial management capacity at the local level is one of the main obstacles to effective decentralisation. Central support in terms of skills training, development of appropriate financial management systems and central monitoring systems are all needed. However, this is also constrained by the limited capacity at the centre in many countries: capacity to know what is going on at the local level, and to take action to rectify failure. Rent-seeking behaviour by central officials and political disputes further weaken the ability of the centre to oversee local government finances. However, it is important to stress again that these are problems inherent in any system that seeks to deliver services, and therefore finance, across the country: they are not unique to decentralised (devolved) systems of government.

Reforms in financial management

Specific reforms to financial management that have been adopted in various places in recent years include:

a) Simplifying accounting systems and making them more transparent; this may include the use of accruals accounting for expenditure, to ensure that expenditure obligations incurred appear in the accounts, even if bills have not been paid;[1]

b) Computerisation of revenue collection and accounting systems, with appropriate safeguards, to facilitate cross-checking and reduce opportunities for individual discretion and manipulation;

c) Paying grants directly from the Ministry of Finance to the bank account of the sub-national government or institution for which it is intended, to prevent money being sliced at intermediate stages;

d) Simplifying grant systems to increase transparency and public understanding, and publicising information about formulae and allocations, including requiring public display of information about resources for particular facilities, services or projects, as in Uganda;

e) Avoiding multiple funding sources for the same activity, which can be used to disguise how the funds are used;

f) Requiring the submission of photographic records of project implementation;

g) Selective use of independent expenditure tracking studies to trace the use of funds (Ablo and Reinikka, 1998; Dehn *et al*., 2002);

h) Clear rules about public procurement, specification of codes of conduct for local officials and elected representatives, and arrangements for asset declarations by elected representatives and senior officials;

i) Systems of monitoring local government performance that feed into the grant system, as used in Kenya and Uganda;

j) Building local accountability through citizen report cards (India), citizen charters, participatory budgeting (Brazil) and access to information.

All this requires a change of culture and practice within central government. Decentralisation involves a shift from a direct role in service delivery to one of enabling and monitoring the work of local governments and other agencies at the local level. This requires the building up of capacity to monitor and verify effectively, and systems that minimise the scope for monitoring to be undermined by rent-seeking behaviour. It also requires central government to play its role within the system properly: dealing promptly with requirements for approval, paying agreed grants and revenue shares on time, and seeking to reinforce good practice at the local level.

Note

1 Under a cash accounting system, it is possible for unpaid debts to accumulate without these being apparent from the accounts. This has resulted in huge problems of inter-agency arrears in many countries, including Kenya, and has disguised the fact that many local authorities are effectively insolvent. On the other hand, use of accruals accounting on the revenue side can present a dangerously misleading picture where revenue collection performance is poor, since unless the debtors position is examined, what the accounts show is the revenue due rather than what has actually been received.

References and further reading

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