

Chapter 6

Nonministerial Government Bodies and Corporate Governance of Public Enterprises

It hardly matters whether a cat is black or white as long as it catches mice.
— Deng Xiaoping, 1963

THE SETTING

The decision tree shown and discussed in Chapter 1 is rooted in the question of how the government should intervene in the provision of goods or services once it has been decided that public interest is at stake and therefore that some form of government intervention is appropriate. (For simplicity, we will use the word *services* from now on to refer to both goods and services.) A first issue is whether the government should regulate the provision of the service by nongovernment entities or should itself be involved in such provision. (Regulation was discussed in Chapter 1 and the organization of regulatory bodies in Chapter 3.)

If government decides to get involved (in a capacity other than regulation), several choices come to the fore. The most immediate is direct provision of the service by a regular organ of government itself—a central ministry, provincial government, or municipality. This is not the only option, however. First, public functions need not be performed or delegated in their entirety; they can be separated into their component parts, some of which can then be assigned to different nonministerial government entities. Second, the public sector is larger than the government; enterprises that are owned in the majority by the state but do not form part of the government apparatus may be well placed to deliver a specific service to the public. Third, government can contract the delivery of public services to private business or nongovernment organizations. The traditional reflex of making government directly responsible for providing services whenever a case can be made for its involvement should therefore be resisted for this reason—and also because the technological, international, and financial developments in the second half of the 20th century (Chapter 1) have weakened the rationale

for such provision. How to choose from among the available options for public service provision depends mainly on the following factors: (i) the nature and importance of the public interest at stake; (ii) the type of service and its users; (iii) the technical and economic characteristics of its production; (iv) the administrative capacity of the government; and (v) the government's ability to exercise adequate control over alternative service providers. All alternative modes of service provision revolve, however, around a basic distinction and three fundamental criteria.

The basic distinction, which is valid for all services whether public or private, is among service *policy*, service *financing*, and service *delivery*. Government can be involved in all three or only one of these aspects, and then again fully or only in part. Hence, at one end of the spectrum, government may be involved only in the partial definition of service policies (e.g., designing urban transport routes to assure service to isolated neighborhoods). At the other end of the spectrum, government may set all policy, provide all the funds, and be directly responsible for delivering the entirety of the service (e.g., national defense). The service provision options can therefore be arranged along a *continuum of government involvement*—from direct and complete provision at one end, to the setting of only a few service policies at the other.

The *fundamental criteria* are good governance, efficiency, and equity. The mode of service provision chosen should, on balance, improve the four pillars of governance: accountability, transparency, participation, and predictability. Improvements in governance may occasionally need to be balanced against significant efficiency considerations or pressing social needs. But in general, as argued in Chapter 1, better governance leads also to higher efficiency and greater equity in the long term. The four pillars therefore provide the best guide for decisions on the modes of provision of services that are the responsibility of the state.

To narrow down the operational choice further, the financing required for providing a public service is expected to come, at least in part, from the government, normally from tax revenues.¹ The task of setting policies regarding standards of service, access, eligibility, etc., clearly pertains mostly to the government as well. In practice, therefore, the concrete choice most often revolves around the entity that should be responsible for service *delivery*. This choice is linked to the general distinction between policy formulation and policy implementation.

This first part of the book focuses on organizational questions, and the previous chapters have examined the organizational structure appropriate to government entities at national or provincial/local levels. In this chapter we examine the organizational issues arising from separating policy from implementation; the ensuing creation and control of executive agencies and other nonministerial bodies; and the question of corporate governance of public enterprises. (The option of contracting out public service delivery to private business or voluntary organizations is discussed under the heading exit in Chapter 13.)

The issue of sound corporate governance in the private sector—both financial and nonfinancial—is very important in all countries, especially in Asia where weaknesses in corporate governance and the financial sector were a major cause of the crisis of 1997–1999. However, this issue is outside the scope of a volume on public sector management and should not in any case be treated briefly and superficially. The interested reader is referred to a synthesis paper on corporate governance by Zhuang, et. al. (1999), and to the extensive references quoted therein.

SEPARATING POLICY FROM IMPLEMENTATION²

The Conceptual Issue

Experience suggests that to improve the efficiency of service delivery, it would be appropriate to distinguish between the policy-making function and that of implementation. (Indeed, as stressed in Chapter 1, it is precisely such a distinction that gives public sector management its instrumental characteristics.) Correspondingly, there is an argument for organizational differentiation between the two functions, which rests broadly on concerns about “focus” or “capture.”

The focus argument, generally made by politicians and public managers, is that policy making and service delivery are distinct functions, each of which can be performed better if it does not compete for attention and management time with the other. Thus, service delivery entities should concentrate on providing quality services efficiently, without the complication of having to evaluate the merits of alternative policies and standards. Similarly, policy making can be more focused, more rigorous, and sometimes even more adventurous without the distraction of operational problems. Regarding reforms in countries in the Organisation for Economic Co-operation and Development (OECD) (see Chapter 20), the debate on

the creation of “executive agencies” in the United Kingdom (UK) and similar developments in Australia, Canada, France, Iceland, New Zealand, and Norway is replete with references to the need for clear, defined targets that allow service delivery entities to concentrate on their core operational business.

The capture arguments, generally made by economists and academics, rest on the common premise that individuals always act according to their self-interest.³ In Niskanen’s argument (1973), because there is no competition for a public service and because growth of the public organization benefits both civil servants and politicians, an alliance between these two groups can obscure the real costs of the public service provided by the organization. Hence, public organizations that systematically tend to be larger than private entities would be in a competitive market under the same conditions, and policy making is captured by the self-serving bureaucrats involved in service delivery. The way to break up that alliance is to separate the political function of policy making from the administrative function of implementation. In a different vein, according to Dunleavy’s (1991) “bureau-shaping” model senior public officials are interested in maximizing the direct running costs of their agency and the funds available for contracting suppliers, and have much less interest in administering the resources passed on to them by other bodies. Hence, it would be in the interest of these officials to relinquish the direct management of some activities, as this would release them from peripheral responsibilities while allowing them to stay in the driver’s seat and continue to increase the resources that matter to them personally.

In either case, the argument is that public entities are prone to capture by the public officials who control them. Separating what the agency should do (policy) from how it does it (implementation) is seen as a key strategy for reducing this risk—whether the separation is viewed as the only route to breaking up the self-serving bureaucracy, or as a way to enable senior officials to bask in the glow of a policy advisory role, freed of operational responsibilities.

These arguments have both merits and weaknesses. The focus argument assumes that policy making is a clearly distinct activity that can be undertaken in isolation from implementation. However, in the real world, policy is partly made or significantly adopted during implementation. The capture argument presupposes that separating policy from implementation reduces the risk that policy will be formulated to suit the interests of the

avored civil servants and politicians—a plausible assumption. However, while separation reduces this particular risk of capture by public servants, it also produces the risk of capture by other interests. Since the quality of policy cannot be assessed before the results are in, the time lag between policy and implementation permits service policies to be tailored to suit particularistic ideological or business interests. When the consequences of certain policies become clear, usually after several years, the special interests who have benefited from them may be long gone. Boston (1995) suggests this as one reason why, even at the height of Managerialist Passion in New Zealand in the early 1990s, in practice policy advice was contracted out much less than might have been expected.

Moreover, where policy is detached from service provision but retained within the public sector, the risk of capture may diminish, but the risk of “ivory-tower” policy making increases. Policymakers not subject to the reality check of actual implementation are increasingly likely to formulate unrealistic or inappropriate policies. And, confronted with such policies, implementers who have no access to the policy-making process become increasingly prone to disregard *both* the unrealistic policies and the sound ones, and accountability is inevitably lost. Corruption risks may increase, too.

Finally, on the empirical side, despite the conceptual arguments in favor of separate organizations, there is no hard evidence that “single-roof” agencies (multipurpose entities that retain responsibility for both policy-making and service delivery) perform less well or are less readily held to account than their single-purpose counterparts (Boston 1996).

When is Separation Appropriate?

Nevertheless, returning to the initial proposition that some distinction between policy and implementation can improve both policy and implementation, it is helpful to summarize some of the conditions for which separate organizational arrangements may be suitable (albeit always with appropriate coordination and never with hard boundaries). Separate organizations for service policy and service delivery may be appropriate when

- policy can be fully specified in advance of action;
- the process of implementation does not raise policy issues;
- policymakers do not need advice from implementers;

- policy can be specified in sufficient detail to cover most eventualities; and
- policy can be specified in terms that allow close monitoring of implementation.⁴

For example, automobile licensing or garbage collection may meet the above criteria, but disease prevention or the production of nuclear weapons do not (Kettl 1993). Thus, while based on the conceptual arguments and counterarguments, the decision regarding organizational arrangements for service policy and service delivery must take into account the characteristics of the specific service—of course, in light of the country's circumstances, the institutional environment, and the government's administrative capacity.

In any event, *creating a demanding public*, through a deliberate strategy and continuing actions to raise public expectations, is more important in improving public services than fine-tuning the organization of the government entities that deliver them. Only an aware and aggressive public can provide effective contestability for *both* the public organizations and the entities to which the services might be subcontracted, and thus reduce the risk of capture by *any* vested interest, public or private. (Chapter 13 discusses the role of “exit” in public administration.)

“EXECUTIVE AGENCIES” AND OTHER NONMINISTERIAL GOVERNMENT BODIES

Executive Agencies

Although agencies charged with service delivery have existed for a long time, in the mid-1980s a number of OECD countries, generally in the British administrative tradition (e.g., UK, Australia, Canada, and New Zealand) began a move to formally separate the organizations and the personnel in charge of policy or implementation. “Executive agencies” (called by different names in different countries) were thus created for the delivery of public services, under policies and service standards formulated by the regular organs of government. At the same time, it was also felt that the commercial functions of government departments should be separated and run as regular commercial operations, as discussed later in this chapter.

In the UK, as the Prime Minister stated in 1988: “To the greatest extent practicable, the executive functions of government, as distinct from policy

advice, should be carried out only by units clearly designated...". Accordingly, many executive functions were hived off into autonomous "Next Steps Agencies," governed under a performance agreement with the competent ministry. The exercise was accompanied by measures to strengthen the policy function of ministries. In New Zealand, agencies have complete managerial autonomy in all matters including personnel, but must satisfy the terms of their output-based performance agreement with the Government. A more moderate system was adopted in Canada, where special operating agencies within ministries were given direct responsibility for results and correspondingly greater management flexibility. However, their employees remain part of the career civil service.

Executive agencies or similar entities have also been introduced in countries not of the British administrative tradition. The Republic of Korea has recently decided to adopt the British model of executive agency for selected government entities such as the national medical centers and the automobile licensing and testing stations. (There are 25 candidate agencies for the next phase in the Republic of Korea.) Similarly, France recently established many state services as special-purpose agencies called "responsibility centers" (*centres de responsabilité*). Jamaica has selected 11 pilot agencies for conversion into executive agencies. The African variant, in countries like Ghana, Kenya, Tanzania, Uganda, and Zambia, has been limited mainly to merging the customs and tax departments, and running them as more autonomous national revenue authorities. Similar experiments have been introduced in several other countries. (Annex II presents good practice in executive appointments to executive agencies which is generally applicable to state-owned enterprises as well).

Typically, as in a private company, responsibility for the day-to-day operations of an executive agency is delegated to a chief executive officer (CEO), who is responsible for all management and service delivery questions within the framework of the policy objectives and resources set by the responsible minister in consultation with the ministry of finance. In the UK, the agencies remain part of the civil service and accountable to Parliament through the minister. A variety of specific organizational arrangements have been followed in other countries. In all cases, however, creating executive agencies is normally accompanied by a shift to accrual accounting (Chapter 7)—necessary to measure the full cost of providing the service; some form of market testing or other exposure to competition; and, logically, measures to give the CEOs full autonomy and control over resources (including personnel management and compensation), in return for accountability for outputs. (See Chapter 18 on performance measurement issues in the public sector.)

As stressed earlier, whether or not it is appropriate to separate policy from service delivery depends on the nature of the service and on the circumstances of the country. And greater autonomy, obviously, always requires stronger monitoring and accountability. When executive agencies are appropriate, therefore, the basic conditions for their successful functioning are as follows

- effective monitoring and adequate measurement by the government of the performance of the executive bodies created;
- stronger coordination of the autonomous agencies, in the national interest;
- robust and effective audit, disclosure, and general accountability mechanisms; and
- the recognition by the agency management that the agency is still part of the public sector. Hence, managerial autonomy must be tempered by self-restraint and awareness of the impact of service pricing and personnel salaries on the access to services and on public perception. Agency managers should be selected partly on the basis of this attitude.

The above conditions are difficult to satisfy (and to maintain if they do exist to begin with). In countries that have gone the farthest along the executive agency and contractual route (e.g., New Zealand), the costs in terms of weaker accountability and fragmentation of state action have begun to emerge and be recognized, with sharp political repercussions.

In developing countries, it would be especially unrealistic to assume the existence of these basic conditions—particularly the capacity of the government to measure and monitor the performance of new, fully autonomous entities. In countries where the government can barely monitor the functioning of the present system (three out of four public enterprises in India, for example, do not even submit the accounts that form the basis for auditing them), moving to a system with far heavier monitoring requirements would be simply unthinkable. To do so would produce none of the advantages of the executive agency model and all of its costs and risks (including greater corruption)—and this in a deprived economic and social environment that can scarcely afford to shoulder more costs and accept greater risks. However, aside from creating separate and fully

autonomous executive agencies, some greater autonomy for the delivery of selected services may be helpful. Also, simplifying inefficient or complex rules and preventing political micromanagement of operational matters are almost always desirable.

Other Nonministerial Government Bodies⁵

During the last century, all countries have seen a rapid growth in the number and variety of public sector organizations that are outside the formal hierarchy of central government but operate under different degrees of government ownership and control. These organizations comprise state-owned enterprises (also called public enterprises), departmental enterprises, and statutory corporations. Public enterprises are expected to operate like private companies and are therefore part of the public sector but not of government. (Governance issues in public enterprises are discussed later in this chapter.) Departmental enterprises and statutory corporations operate within various legal and institutional rules and have varying degrees of autonomy, but are all subject to government control for specified results and operations, as well as to legislative oversight. Such nonministerial government entities can be set up concurrently under central and subnational levels of government, depending on the political structure of the country.

The growth of nonministerial government bodies is related to both of the trends discussed earlier—expanding government regulation and the drive for separate service delivery. Many nonministerial bodies are independent regulatory entities. And, once the government decides to continue providing a certain service, but not to proceed to a full separation between policy and implementation, it can assign the service delivery (and the corresponding staff) to a range of nonministerial bodies, with autonomy intermediate between that of a traditional ministerial department and that of an executive agency.

Nonministerial bodies vary considerably in their organizational structure. As noted, these bodies are distinguished from ministerial departments primarily by their greater degree of autonomy and more flexibility in resource use and personnel management. However, the term nonministerial should not be taken to mean that all such bodies are outside the ministerial hierarchy. In most cases, they are accountable to the minister concerned and to the legislature through the ministry. In Japan, for instance, the Prime Minister's Office controls several autonomous agencies such as

the Fair Trade Commission, Management and Coordination Agency, Economic Planning Agency, Science and Technology Agency, Environment Agency, National Land Agency and Defense Agency. In fact, many formerly independent public agencies in Japan were eventually absorbed by the latter.

Similarly, India has departmental enterprises that operate as manufacturing units and run commercial operations, such as the railways, postal services, public transport, and even defense supplies. Although these enterprises are nominally separate from the ministry, their senior officials do not have much greater autonomy than that allowed in traditional ministries, and their budget is part of the annual government budget voted by the legislature (although special funds may be set up to preserve the commercial character of the enterprises). This system is akin to that of the departmental and municipal enterprises in eastern Europe, which have proven difficult to reform.

In France, a variety of administrative authorities have arisen alongside the ministries in the last 20 years. They either protect the people's rights (those agencies interposed between the public administration and the courts, e.g., the Commission for the Control of Security Interceptions) or assist in market regulation (e.g., the Securities and Investment Board, the Telecommunications Regulatory Board, and the National Broadcasting Authority). Examples of similar agencies with regulatory powers can be seen in many developing countries, especially as a result of the need to regulate the outcomes of liberalization and privatization.

Of an entirely different genre are the crown entities in New Zealand. They are owned by the Government and provide goods or services on behalf of the ministerial departments, but are legally distinct entities established under separate enabling legislation. Functions entrusted to these entities vary from regulation and purchasing, to service delivery and even policy advice. The restructuring of the health sector, for example, led to the creation of four regional health authorities and one Crown Health Enterprise.

Similar to these crown entities are statutory boards. A statutory board is an autonomous government agency set up by special legislation to perform specific functions. It does not enjoy the legal privileges of government departments, but is given greater autonomy and flexibility by law. Singapore since the early 1970s has organized much of the work of government around

statutory boards, freed from the inefficiency-causing constraints of the civil service, and in the process has reduced the workload of the ministerial departments. The 26 statutory boards in Singapore perform functions related to economic development, the development of infrastructure and essential services, education, tourism, and sports and recreation activities. The salary scales, conditions of service, and provisions regarding promotion and discipline vary according to the functions of the boards. In fact, one reason for establishing the statutory boards was to stop the loss of talented civil servants to the higher-paying private sector. Similar entities set up as cooperatives or not-for-profit organizations in other countries operate autonomously, but with substantial ministerial control over their governing boards.

PUBLIC ENTERPRISES AND THEIR GOVERNANCE⁶

What is a Public Enterprise?

A public enterprise (PE) is an enterprise of which more than half is owned by the state, directly or indirectly. This seemingly obvious definition was arrived at in the late 1980s after much international debate, and is important insofar as it is based on ownership rather than control. Thus, if 51 percent of enterprise A is owned by enterprise B, of which 51 percent is owned by enterprise C, of which 51 percent is owned by the state, all three enterprises are by definition public enterprises, even though the state owns only 26 percent of enterprise B and 13 percent of enterprise A. In effect, therefore, a private enterprise can be controlled by the government, and a public enterprise by private interests (although in most cases PEs are effectively controlled by government). However, a definition based on ownership is the only one that permits public enterprises to be identified as a separate category. The criterion of effective control, on the other hand, would require a case-by-case analysis of the enterprise share structure, which would, moreover, have to be reviewed each time there is a shift in shareholders' alliances.

In many countries, especially the transitional economies, public enterprises have been the principal instruments through which the state has fulfilled its role. In developing countries their growth through the 1960s and 1970s was usually seen as indispensable for development, owing to the imperfections of the market mechanism in those countries. This original rationale for their existence was, however, stretched much too far in most countries, extending to state ownership of shoe manufacturing and ice-

cream factories on the grounds of national interest. Also, in many industries where the original rationale for public enterprises applied, rapid changes in technology and communications later intervened to render them unnecessary. Quite aside from ideological predilections and power shifts, the PE sector in most countries at the beginning of the 1980s was ripe for substantial pruning, rationalization, and privatization.

The Importance of Good Corporate Governance of PEs

This book is not concerned with privatization *per se*. Privatization is the process of moving assets *out* of the public sector, and by definition is not part of the management *of* the public sector. Moreover, privatization entails special processes, skills, and considerations, and is in many ways a separate area in its own right. Instead, for those PEs that are slated to remain in the public sector indefinitely and those whose privatization takes a long time, efficient and accountable mechanisms must be in place to manage, control, and protect the enterprise assets. These functions of *management, control, and asset protection* are subsumed under the label of corporate governance, and corporate governance of PEs is an important dimension of public sector management.

In the early 1990s, many countries made the fundamental mistake of viewing improvements in the corporate governance of PEs either as irrelevant to the basic policy of privatization or an obstacle to it. Their reasoning was peculiar: the worse off the public enterprises were, they thought, the greater would be the pressure to privatize them. The same frame of mind produced a headlong rush to privatize, for the equally peculiar reason that quick privatization was a good thing—no matter if it put valuable public assets in the hands of corrupt associates of public officials or enterprise managers, and at a tiny fraction of their true market value. These views affected primarily the transitional economies of eastern Europe and the former Soviet Union. In these cases, the rationale was mainly that rapid privatization was needed to make irreversible the change away from central planning. But the fallacy of viewing better governance of public enterprises as inimical to their eventual privatization has surfaced in other countries as well, and so has the failure to understand that “quick and dirty” privatization may or may not produce short-term efficiency gains but cause damage to the fabric of governance, which is far more costly in the long run.

Corporate Governance in the Context of Overall PEs Reform

Improvements in corporate governance of PEs are the internal side of PE sector reform. In brief, there are five *external measures of PE reform*.⁷

- *Privatization*, which reduces political influence on the management of the enterprise, transfers risk to the private owners, and can provide powerful incentives for efficiency gains, reduced waste, etc.
- *Strengthened competition*, through the removal of price controls, unnecessary regulation, and barriers to entry, compels better performance and enables a fairer assessment of the enterprise's efficiency relative to its competitors.
- *A hard budget constraint* and removal of subsidies induce efficiency improvements in the enterprise.
- *Financial sector reforms*, put the hard budget constraints into effect.
- *Restructuring* public enterprises consists mainly of the spin-off of competitive businesses and peripheral activities from the public goods core, the separation of operational functions from policy and regulatory functions, and the breakup of monopolies into smaller competing units.

Good corporate governance reinforces the external reform measures, as it helps enforce financial discipline, entails transparent rules instead of personalized interventions, and protects public assets from undue appropriation by insiders. Improved corporate governance is particularly important in developing countries and transitional economies because the other checks on the behavior of managers, such as rating companies, public assessment by financial investors, and the capital market, are still undeveloped. Indeed, improvements in corporate governance facilitate eventual privatization, but in the transparent and accountable manner necessary.

Elements of Corporate Governance of PEs

The main elements of corporate governance improvements are (i) corporatization; (ii) representation of the state by an agent; (iii) management improvements; (iv) the protection of shareholders' interests by the board of directors; and (v) performance and management contracts.

Corporatization

In many countries, the distinction between the roles of owner (principal) and manager (agent) of a PE has become blurred, contributing to the poor performance of enterprises and in some cases to corruption. Separating the roles of principal and agent is the first step in improving corporate governance. Corporatization is the setting up of an independent legal identity for the enterprise, separate from the identity of the state as owner, and usually entails placing public enterprise operations under the rule of commercial law like private enterprises.

Corporatization almost always results in a net increase in the efficiency of allocation and use of a country's economic resources. This was shown, among many other examples, in the case of Canadian Railways; British Steel; the German railways in 1994; and—possibly the most striking example—French telecommunications, which underwent a highly successful transformation in 1990 from a government department into France Telecom, a still public but corporatized entity functioning in a competitive environment.

For transitional economies and developing countries, besides the efficiency gains, corporatization of state enterprises can help establish clear title, and sort out the web of relationships among enterprises, their subsidiaries, and government ministries. This is a first step to establishing a hard budget constraint on the enterprises. Clear title also facilitates the disposal of assets and enterprise restructuring. Corporatization has often been a first step to privatization.

Some resistance to corporatization is to be expected but need not be a stumbling block if the process is open and well handled. In New Zealand, before every corporatization, company management invariably warned the Government of anticipated resistance from unions. The resistance, however, never materialized because the government effectively communicated to the workers the reasons for and benefits of the corporatization process, and provided suitable compensation to redundant workers. Similarly, the changes in French telecommunications were perceived as a veritable cultural revolution at first. The Government brought together the public, customers, and employees to discuss the problems of the sector as a whole and to consider future directions; launched a wide-ranging internal and external debate; negotiated with the unions; waged an intensive public information campaign; and amended the corporatization plans to incorporate the results of the dialogue.

In fact, experience generally shows that resistance to corporatization of PEs comes neither from the enterprise workers nor the general public if the process is managed well. Far stronger resistance comes from the enterprise management and from the sector ministry concerned—one reluctant to face direct accountability, the other unwilling to accept loss of power and influence over the operations of the enterprise. This alliance between bureaucrats and politicians is a good illustration of Niskanen's "capture" argument mentioned earlier, and corporatization—clearly separating the two interests—is in this case the best policy. For this reason, sector ministries should be excluded when designing the corporatization of enterprises in their sectors.

Selecting an "agent" to represent the state and establishing oversight

In its role as "owner" of an enterprise, the state must ensure that the enterprise is run and its investments are made with a view to maximizing the benefits to society. Of course, it must exercise that role through a specific entity. Different countries have attempted different solutions to the problem of who should exercise state ownership rights. Some have set up a public agency for the purpose, while others have split the responsibility among several existing agencies or entrusted the role to sector ministries or created a holding company. In general, the preferred solutions are those that establish a uniform set of procedures for all enterprises, without blurring lines of accountability or combining different roles in the same agency or relying on sector ministries.

To illustrate the problem of confused accountability, the *régies autonomes* of national interest in Romania are supervised directly by the relevant sector ministry, but with the involvement of other ministries, particularly the Ministry of Finance. The problem of multiple roles is exemplified by the case of the Russian State Property Committee (GKI). It holds the shares of both the PEs that are to be sold and those that are to remain in public hands, so that the pressures of privatizing some enterprises often pushed the task of managing the assets of the others into the background. In New Zealand, the move to allow the sector ministries to exercise ownership rights failed for two related reasons. First, the public enterprise in effect captured the parent ministry. (The Ministry of Civil Aviation, for example, routinely supported Air New Zealand's expansion plans.) Second, the shortage of business skills in government ministries prevented effective control. Indeed, experience has shown that the main opposition to a uniform organizational arrangement for PEs has come from

the attempt to preserve old patterns of personal relationships between enterprise management and sector ministries.

Austria and a few other countries tried to solve the problem of who should exercise state ownership rights by creating a “holding company,” that is, a corporation to hold the state’s shares in public enterprises as well as manage the enterprises themselves. Through such companies, those countries hoped to curb abuses by enterprise senior managers, and to reduce the operational interaction between the government and the state enterprises by interposing an intermediate layer. However, the holding company *itself* is not subject to effective governance by the state. Also, in practice a holding company tends to enlarge its influence by maximizing the budgets of the enterprises it owns, controlling competition, and protecting failing companies through cross-subsidization—rather than managing the enterprises on the basis of efficiency and market criteria. Finally, state holding companies are normally supposed to be transitional, but pressures from various stakeholders tend to prolong their existence. International experience points to the longevity of both the holding companies and their subsidiary enterprises, due to their capacity to bargain for and sustain the flow of government subsidies. The best example is the Italian state holding company *Istituto per la Ricostruzione Industriale* (IRI). IRI was obliged *by law* to dismantle itself within five years of its start in 1948, but this obligation did not prevent it from becoming one of the largest industrial conglomerates in Italy over the next 40 years.

Holding companies are therefore not a good general model. However, holding structures for managing decline in specific sectors might be feasible for a limited time, with appropriate accountability safeguards and an irrevocable sunset clause (following the German example of the *Treuehandtstalt*, which managed the reform and restructuring of the industrial sector of the former East Germany).

On balance, experience suggests that governments should set up a central public agency to exercise state ownership rights in public enterprises but without great management responsibilities. New Zealand, in fact, chose this solution after ministerial oversight failed (as mentioned earlier). The Government created a single asset management agency that was close to, but separate from, the Treasury. The agency concentrated on performing the shareholder role, and hired staff with business skills who learned to identify early signs of failure. Because the same agency monitors many enterprises, it is able to take a national overview of all the corporations, and it has so far been very successful.

Improving management of PEs

The effectiveness with which public enterprises are able to adapt to competition and fulfill their mandate depends largely on the integrity and competence of their top managers. However, these are qualities for which PE management has not traditionally been known. In the context of increased autonomy, it is important, therefore, to improve PE management as well, by retraining managers or training new ones; bringing in new blood, improving selection, and focusing on performance. Training issues are discussed in Chapter 12. We review below the latter two: selection and performance evaluation.

Entrenched personal relationships and opaque selection procedures are the most important problems that go with selecting top managers for PEs. It is a fact that governments exert substantial influence in the appointment or removal of senior managers of PEs. In France, for example, the Government in effect appoints the chief executives of Gas of France and Electricity of France by requiring board members to vote for a particular person. However, governments should have a major say in the selection, but not the only say. For example, in Canada, ministers participate with the PE supervisory board in selecting managers, who are then appointed by the cabinet.

Transitional economies and many developing countries are moving away from the traditionally opaque and discretionary processes of recruitment toward more transparency. In Hungary, company directors are appointed by the privatization minister, but the appointments are screened by a parliamentary committee, and other countries have made the selection competitive to ensure a more open process. However, it would be unrealistic to expect long-standing personal connections between top bureaucrats and top PE managers to simply wither away with the introduction of new formal rules. It is important therefore also to skew actual incentives in the right direction. In Poland, managers of enterprises in sectors open to privatization are given a percentage of the value they add to the firm in preparation for its privatization, as a strong positive incentive for efficiency.

Concerning manager's performance, the first reality to consider is the information asymmetry that exists between government outsiders and enterprise insiders. Without relevant information, performance evaluation becomes merely an elaborate "snow job." It is accordingly necessary for the government, as it introduces performance evaluation for PE managers, to

develop at the same time channels of reliable information, e.g., independent feedback by employees or consumers.

It must also be possible to remove nonperforming managers. This is especially tricky in public enterprises because of the close personal connections of the management with high-placed bureaucrats, as noted earlier. In the transitional economies of eastern Europe and the former Soviet Union in particular, many enterprise managers have acted as if they were the owners. More generally, the balance of power between the sector ministries and the PE managers is often tilted in favor of the latter, who have direct access to assets and resources. To improve accountability and thus PE performance, four approaches can be helpful.

- Develop independent channels of information for the government, particularly among the clients of the enterprise.
- Empower one entity to remove nonperforming managers, separate from the sector diversity.
- Give sufficient status to that entity by raising its pay and prestige of its members, and assure it of the highest level political support;
- Decouple the managers from their traditional patrons in the ministries.

Protection of shareholders by the board of directors

In both public and private enterprises, the board of directors is the intermediary between the owners and the managers that protects shareholders' interests by ensuring management performance and accountability. The state as owner can either delegate the control function to a board of directors, or can negotiate performance (or management) contracts. In general, the choice between performance contracts or boards of directors depends on the availability of competent persons of integrity to serve as members of boards on the one hand, and, on the other, on the government's capacity to prepare, monitor, and enforce performance contracts. Performance and management contracts are discussed in the next section. Immediately below we summarize the results of international experience with boards of directors of PEs.

The board of directors must be created in such a way as to ensure an arm's length relationship between the PE and the government. With this in mind, some countries (e.g., Germany, Hungary, Netherlands, Poland, and Ukraine) have adopted a two-tiered board structure, while others (e.g., France, Italy, and Romania) follow a unitary structure. The two-tiered board

consists of a supervisory board with nonexecutive members appointed by the government, and a management board with executive members nominated by the supervisory board itself (or jointly with the government). A unitary board has both executive and nonexecutive members. Generally, the unitary system is simpler, clearer, and avoids conflicts between the two boards. In developing countries, which often lack qualified persons to serve on enterprise boards, the system is also more realistic. However, the choice between a unitary and a two-tiered board depends on the characteristics of the country and the preferences of the government. The widespread adoption of the German model in eastern Europe, for example, is explained largely by the desire to involve workers in company governance (they select some of the members of the supervisory board).

To be effective, all boards must walk a fine line between conflicting demands. They must exercise their legal oversight responsibility, but without stifling the initiative of the management; and they must represent the interests of the state, but without becoming involved in the operational affairs of the company. Their capacity to walk that line depends far less on the structure of the board than on the capacity of its members, the quality of the information and resources they have, and the degree of government support they receive.

An examination of the way the boards of directors of public enterprises function in transitional economies and developing countries shows a number of common problems, most of which can be traced back to the difficulty of establishing effective board control over PE managers. This difficulty has four main causes.

- First, governance weaknesses make for easier capture of board members by enterprise managers (who control information, valuable assets, and patronage possibilities). In most developing countries, managers retain a great deal of leeway within the existing rules, and—protected by their patrons in the sector ministries—are rarely punished for violating the rules.
- Second, lack of experienced board members weakens supervision. The limited availability of skills and the need to establish boards for a large number of PEs tax the system's capacity to staff the boards properly.
- Third, many countries draw PE board members from among current and former government employees, who do not have the business expertise required and may rely on the PE for political patronage or a source of future employment or both.

- Finally, in many countries, board members have insufficient incentives and resources. They are often very poorly paid, lack the necessary supplies, and do not have enough funds to travel and inspect company operations.

Performance and management contracts

The alternative to a board of directors is a performance or management contract. Performance contracts are agreements between governments and *public* managers; management contracts are between the government and *private* managers. Performance and management contracts respond to different needs and have distinct requirements. Performance contracts also go by other names, such as contract plans, program contracts, memorandums of understanding, signaling systems, and public utility licenses.

In a *performance contract*, the government sets strategic objectives and the public managers decide on the operational strategy to achieve those objectives. The process of developing performance contracts is beneficial in itself, as it leads to a dialogue on facts and helps each party become familiar with the needs and problems of the other. Most performance contracts are indicative rather than prescriptive, and their success depends more on genuine commitment by both sides than on the degree of contract detail.

Of the various experiences with performance contracts, generally the most disappointing have been in developing countries (especially in Africa). In transitional economies they have been of some utility. The effectiveness of performance contracts depends, among other things, on the availability of comprehensive and reliable information, strong administrative capacity, and a pool of highly competent and committed public managers. It is not surprising therefore that by far the most successful experience with performance contracts is that of the Republic of Korea and New Zealand (Box 6.1). More mixed has been the experience of the People's Republic of China (Box 6.2). A hypothetical illustration of how an actual performance contract is drafted is shown in Box 6.3.

Box 6.1
Successful Performance Contracting
in the Republic of Korea and New Zealand

The Republic of Korea has had a highly successful experience with performance contracts as well. As part of the 1983 reform of public enterprises (PEs), the Government entered into performance contracts to permit a comparative evaluation of the short- and long-term performance of all PE managers. Rewards are linked to performance, as evaluated by independent auditors. Performance indicators are used to measure results against the trend, as well as against agreed targets. Seventy percent of the indicators are quantitative and are set annually; these include profitability and productivity, as well as sector-specific indicators. Qualitative indicators include corporate strategy, research and development, and improvements in management information and internal control systems. These indicators are combined into a single public profitability measure using a weighted average of performance with respect to each indicator.

The New Zealand approach to performance contracting, used since 1986 and expanded in the 1990s, includes a statement of corporate intent for each state-owned corporation, which is redrafted each year to define precisely the goals, targets, and subsidies for noncommercial goals. Improvements in productivity, profits, and customer service have been significant, and in some cases dramatic, and lower prices have been instituted.

Box 6.2
Performance Contracts in the People's Republic of China

The People's Republic of China was the first transitional economy to introduce performance contracts. Beginning in 1987, a variety of contracts were introduced under the contract responsibility system. All of these gave managers of industrial public enterprises (PEs) greater control over enterprise operations in return for meeting profit remittance targets. Many contracts also gave the PEs greater autonomy over sales and permitted managers to grant employee bonuses and hire contract workers. In 1992, a government directive stipulated that contracts could grant managers additional autonomy, including the rights to make production decisions, determine prices for outputs and inputs, purchase goods and materials, make investment decisions, hire workers, and determine wages and bonuses.

The extent to which these contracts have improved performance is difficult to assess. In general, enterprise performance improved, but increasing competition from the nonstate sector may have been the key factor. Performance contracts in the People's Republic of China, moreover, while providing incentives for good performance, have failed to penalize bad performance.

Box 6.3

Drafting Performance Contracts with State Enterprises: An Illustration^a

At the start of the year the enterprise signs a performance agreement setting the following targets.

Performance Agreement Targets

Criterion	Unit	Weight	Criterion Values				
			1 Excellent	2 Very Good	3 Good	4 Fair	5 Poor
Gross Profit	million	.50	400	385	350	300	250
Exports	million	.30	80	70	65	60	55
Project Implementation	month	.20	6	8	12	14	16

At the end of the year the achievements of this enterprise are as follows:

- Gross profit: 385 million
- Exports: 65 million
- Project implementation: 6 months

Accordingly, the weighted score is 2.10, as shown below. A score of 1.0 would indicate excellent performance and a score of 5.0, poor performance. The weighted result is the key concept of all performance contracts, for it measures the ability of the enterprise to meet its commitments and allows the evaluation of management.

Calculation of Composite Score

Criterion	Unit	Achievement	Raw Score	Weight	Weighted Raw Score
Gross Profit	million	385	2	.50	1.00
Exports	million	65	3	.30	.90
Project Implementation	months	5	1	.20	.20
					2.10

^a Adopted from an actual agreement prepared by Prajapati Trivedi of the World Bank for Thailand.

Management contracts can take the form of a lease (where the government receives a fixed rent), a concession (where the government is responsible for fixed investments), or a joint venture (where the private manager owns part of the equity). Management contracts in the developing world, especially of the lease or concession type, have often proved to be a blank check to the private management firm to milk the company out of its assets (sometimes in collusion with some high officials) and leave it in far worse shape than before. Partly because of this unsavory experience, no government has adopted management contracts as an important instrument of PE reform, and in no country do such contracts cover a large proportion of PEs. Joint ventures are a little better, but still risky.

However, management contracts can be a useful instrument in particular circumstances, when

- it is particularly costly for government to manage the enterprise directly;
- enterprise technology is not changing rapidly;
- output is homogenous;
- the supplier has an international reputation to protect and quality is easily compared (as with hotels);
- the enterprise faces severe managerial difficulties and needs to rehabilitate a major part of its operations, or government wishes to put in order the financial affairs of a state-owned enterprise before privatizing it; and, most importantly,
- government has the capacity to design a good contract and monitor it closely.

KEY POINTS AND DIRECTIONS OF IMPROVEMENT

Key Points

Direct government delivery of public services is only one option for government intervention. Public services may be also delivered by autonomous public entities, private businesses, or nongovernment organizations (NGOs). The basic distinction is between service policy, service financing, and service delivery. Depending on the nature of the service and on administrative capacity, appropriate government involvement is a continuum—from full and direct involvement in all aspects of service provision to only setting a few basic rules.

The distinction between the policy function and the implementation function has recently led some developed countries to a complete separation between the government organization charged with setting policy and an executive agency entrusted with service delivery—fully autonomous and responsible for results. The conceptual justifications for such complete separation have been the need for the leadership to focus on policy without operational distractions, or the risk of capture of policy by the bureaucracy that delivers the service. However, when policy is fully divorced from implementation, a policy focus can easily become a policy ivory tower. Also, while separation reduces the risk of capture by bureaucratic insiders, it creates a new risk of capture of the public service by private outsiders. When, as in developing countries, government has a weak capacity to measure results and monitor behavior of autonomous entities, the executive agency model is especially hazardous.

Aside from executive agencies, the drive for alternative modalities of service delivery has led to the growth of various nonministerial government bodies. Because they are intermediate between direct service delivery by a regular ministry and a fully autonomous executive agency, such bodies have more autonomy and flexibility than the former but are subject to a greater degree of government control than the latter.

Historically, PEs (i.e., enterprises majority-owned by the state, directly or indirectly) have played an important role in the continuum of service delivery. Their rapid and largely excessive growth in the 1960s and 1970s, combined with the technological and informatics advances of the 1980s and 1990s, has produced in most countries a bloated parastatal sector badly in need of reforms. Among these reforms, privatization is the best known and often the most appropriate. However, a number of public enterprises will remain in the public sector indefinitely, and others will take a long time to privatize. Clearly, there is a need for efficient ways to manage and control these enterprises and protect their assets—corporate governance. Corporate governance is therefore a component of public enterprise reform, not an alternative to reform. The main dimensions of corporate governance are as follows.

Corporatization is the setting up of a separate legal entity for the enterprise, which thus becomes subject to ordinary commercial law. It has resulted in major efficiency gains, and has the added advantage for developing countries and transitional economies of classifying legal title and sorting out property rights. Resistance to corporatization comes typically

from enterprise managers and their patrons in government, rather than from the employees, if the corporatization process is managed fairly and transparently.

The problem of *selecting an agent* to represent the state has different solutions. Experience suggest that the best solution, on balance, is to create a central public agency to exercise the state ownership rights in the public enterprises, but without managing the enterprises themselves.

The challenge of *improving management* can be met primarily by better selecting managers and evaluating performance, both of which call for developing independent channels of evaluation, locating the authority for managers' selection and removal in one entity, and severing the links between managers and their patrons in the ministries.

The main options for an arm's length relationship between the government and the enterprise, which still protects the public interest and the enterprise assets, are a board of directors and a performance or management contract. There are various ways to structure *boards of directors*, but the common problem is to assure effective board control over enterprise management. The effectiveness of *performance contracts* (between the government and a public manager) depends largely on the availability of reliable information, strong administrative capacity, a pool of competent public managers, and genuine commitment from both sides. Consequently, performance contracts have been effective only in the few countries that possess those characteristics, and ineffectual elsewhere. *Management contracts* (between the government and private management groups) have often been a blank check for private managers to strip the company assets or milk its profits, and are to be avoided unless they entail large equity participation by the private managers. Even then, close monitoring by government is a must, and management contracts are therefore extremely risky in developing countries.

Directions of Improvement

Because direct government delivery of public services is only one of several options, developing countries should periodically reexamine the effectiveness of direct delivery of public services relative to possibilities for the involvement of private businesses and NGOs. This is especially advisable in local government, which is normally responsible for providing those services that are generally more suitable for nongovernment delivery. Close monitoring is needed, however, to prevent service quality and access from declining as a result of "capture" by powerful local private interests.

A similar middle-of-the-road approach is advisable for handling the relationship between service policy and implementation. A sharp separation between the two functions is inadvisable in most countries, and the creation of an autonomous “executive agency” exclusively responsible for service delivery is an especially bad idea in developing countries. However, the two functions are in fact distinct. It is advisable for countries, within the existing organizational arrangements, to consider ways in which to sharpen the focus on formulating good service policy and standards, while at the same time giving more flexibility to government managers in the actual delivery of the public services. The appropriate improvements will depend largely on country characteristics, the service in question, and the organization of the government. Generally, however, the issue of how to give greater freedom to government managers to deliver services more efficiently should be viewed in conjunction with budgetary procedures (especially the desirability of some flexibility in reallocating budget within the same category) and the mechanism evaluation of public managers’ performance.

In a majority of developing countries and transitional economies, the PE sector as a whole is a drain on the public finances, without an offsetting benefit in terms of providing services to groups that would be underserved by private business. There is therefore a strong case for *both* reducing the size of the sector through privatization and improving the efficiency and responsiveness of enterprises that remain in the public sector. Because privatization carries special risks in countries with governance weaknesses, developing countries should pay close attention to the process of privatization, with all the expert assistance they can obtain. External donor agencies, too, need to shift their focus from the quantity to the quality of privatization, from the “what” to the “how” of the handling of privatization.

Concerning the improvement of the efficiency and responsiveness of the remaining PEs, reforms in corporate governance are necessary in many developing countries and most transitional economies. In this area, the selective approach recommended above is not desirable because corporate governance reforms and procedures must be uniform for the entire sector.

The following measures, among others, can help ensure the benefits of corporatization.

- Establish a single corporate form and avoid both hybrid organizational solutions (which blur accountability) and sector-specific schemes (which permit the ministries to retain undue influence).

- Ensure open communication and credibility, particularly the employees.
- Monitor the activities of reluctant enterprise managers during the corporatization process.

In selecting an agent to represent the state, it is preferable to establish a single central public agency rather than split the oversight role among different agencies, or entrust it to an existing entity with a different mandate. Such a central public agency would be responsible for the oversight of every PE, but the regulatory function should be vested in separate agencies to avoid conflicts of interests.

When considering the creation of a board of directors, the following are needed.

- First, evaluate whether a board is preferable to other mechanisms of effective control, based on the availability of good board members and the size and nature of the enterprises in question.
- Clarify board objectives and give the board adequate authority.
- Select independent and competent board members representing different constituencies—predominantly from the private sector.
- Help boards organize themselves and provide training where lacking. The formation of an institute for directors to provide such training is worth considering, ideally on a subregional basis for several countries.
- Provide adequate incentives and accountability systems. Board members' remuneration must be competitive with that of the management of enterprises, and procedures must be established to review board members' performance, including in particular the robustness of their supervision of enterprise management.

Performance and management contracts are not a panacea and are in most cases problematic. Therefore

- performance contracts should be used selectively;
- the information on which the enterprise performance targets are set should be made available to both parties;
- an independent body should be established to act as an arbiter and conflict resolution mechanism;

- performance indicators should be derived from an agreed three- to five-year plan, and performance targets should be adjusted only when major factors outside the control of managers change;
- once performance targets have been set, managers should be free to manage, subject only to general government policies and contractual provisions;
- if circumstances are not conducive to detailed performance contracting, a performance agreement can still provide the basis for a constructive dialogue on performance, provided that significant positive or negative consequences result for the enterprise managers; and
- because of the severe risks of management contracts with private managers in developing countries, when it is absolutely necessary to enter into such contracts the government should consider hiring an independent external entity to monitor and supervise the management on its behalf.

Annex II

GOOD PRACTICE IN EXECUTIVE APPOINTMENTS TO NONGOVERNMENT PUBLIC BODIES⁸

Appointments

Appointments to the boards of executive public bodies should be made on the basis of merit, to ensure balance of relevant skills and backgrounds.

Responsibility for appointments should remain with Ministers, advised by committees that include independent members.

A public Appointments Commissioner should be appointed to regulate, monitor, and report on the public appointments process.

The process should be open and dependents should have to justify any departures from best practice. Job specifications should be published and a wide range of candidates should be sought. The suitability of each candidate should be assessed by an advisory committee.

Propriety

Each executive should have a code of conduct for board members, and a similar code for staff.

A consistent legal framework should govern propriety and accountability in public bodies.

Openness and independent monitoring are important safeguards of propriety and should be extended. In particular, staff should have a confidential avenue to raise any concerns about issues of propriety.

The responsibilities of accounting and audit officers for propriety as well as financial matters need to be emphasized.

Appointments Procedures

Defining the task (job description) and the qualities sought ("person specification")

- Job descriptions and a summary of the key qualities sought ("a person specification") should always be documented, be publicly available, be sent to all candidates, and be held for scrutiny by the Public Appointments Commissioner.
- A description of the appointments process should be similarly documented and made available.

Identifying a field of candidates

- A wide field of candidates should be obtained by making appropriate use of
 - advertising—both for general and individual posts;
 - executive search;
 - consultation with interested bodies, which should always include any recognized consultative/user groups and, for local appointments, the elected local authorities; and
 - maintaining and using databases of interested and appropriate people.
- It should always be possible for anyone to nominate anyone, including himself, and this should be made clear in all advertising and publicity.

Selecting a short list and recommending candidates to ministers

- The sifting of candidates should be undertaken or overseen by committees or panels with independent members.
- Any candidate recommended to ministers should have been approved as suitable for the post by the committee or panel, taking up references where appropriate.

Choosing the preferred candidate(s)

- Appointments should be based on merit to achieve a balance of relevant skills and backgrounds on the board.
- Candidates should not normally be appointed without having been interviewed either by the advisory committee/panel or, in the case of more senior appointments, by ministers or senior officials.

- Reappointments should not be automatic. The performance of the postholder should be reviewed.

Confirming the appointment

- All appointments should be announced through press notices and other suitable means—either individually or for minor appointments in quarterly batches—and departments should report annually on their procedures.
- Sponsor departments and individual NDPBs and NHS bodies should have lists of their members that outline who they are and when their term expires.

Openness

Access to information

- Adopt a specific code on access to information incorporating the government's code, and building on it where possible.
- Establish clear and published procedures for implementing the code, including
 - well defined criteria for information that will be withheld, which should be cited whenever a request for information is refused;
 - standards for speed of response to inquiries (e.g., information to be provided normally within 21 days or correspondent informed of likely date);
 - an appeal mechanism, within the organization initially and then either to the ombudsman, or (where the body does not come under the ombudsman's jurisdiction) to another independent person appointed for the purpose; and
 - a policy on charging for information provided (with requests requiring only a reasonable amount of work incurring no charge).
- Provide information on executive salary levels, and average staff salaries.

Meetings

- Open meetings to the public or make minutes of meetings (and main committees) available for public inspection or describing key discussions and decisions in newsletters etc. after each meeting. Some items may be deemed confidential but the criteria for doing so should be published.

- Open to public and media a well-publicized annual general meeting, allowing an opportunity to question the board members on the performance and activities of the body.
- Other opportunities should be taken to involve and inform the public and organization with a major interest on major issues, through consumer groups, user forums, or public meetings.

Publications

- Annual reports and accounts should include information on the role and monolith of the executive body, long-term plans or strategy; membership of the board, performance against key targets; targets for the forthcoming year; their commitment and approach to open government; and where further information can be obtained (including how to inspect the register of board members interests and how to pursue complaints).
- Publish other important information depending on the body, including key statistic, the results of consultation exercises, details of key procedures (e.g., criteria for allocating public funds), and reports of regulatory investigations.
- All publications should be made as widely available as possible, such as through public libraries, and all annual reports and accounts should be deposited in the official government.

NOTES

¹ For major infrastructure projects, however, the forecast needs are so huge that most of the financing will need to come from private sources.

² We are grateful to Nick Manning for contributing much of the substance of this section. His contribution has been edited to fit the structure and thrust of the chapter, and combined with other materials. The authors claim responsibility for the views expressed here and for possible errors.

³ See especially the contributions of Niskanen and Dunleavy, summarized among other theories in Pollitt, Christopher, et al. (1998).

⁴ As Stewart (1996), puts it, “separation of policy-making and implementation will not prove the elixir that will resolve many of the problems of public management... It should be seen as *one approach* rather than *the approach*.”

⁵ This section relies on Commonwealth Secretariat; and Nellis and Shirley (1991).

⁶ This section relies largely on Schiavo-Campo and Pannier (1994), “Corporate Governance of Public Enterprises: The Comparative Experience.”

⁷ See Pannier and Schiavo-Campo (1994) for a fuller discussion.

⁸ Adopted from the first report of the UK Committee on Standards in Public Life.

PART II

MANAGING GOVERNMENT RESOURCES

Chapter 7

Managing Central Government Expenditure

It is better to rise from a banquet neither thirsty nor drunk.
—Aristotle

This chapter provides a quick run-through of the entire public expenditure management (PEM) cycle. The key message is that the management of public expenditure is neither a purely technocratic issue nor suitable for simple quick fixes, on the one hand, yet is always amenable to some practical improvement, on the other. Principles and practices of subnational government expenditure are examined in Chapter 8. Here we focus on central government expenditure management. Because of the summary nature of this discussion and the technical dimension of the subject, the reader interested in a fuller explanation is referred to Schiavo-Campo and Tommasi, 1999.

THE OBJECTIVES AND CONTEXT OF PUBLIC EXPENDITURE MANAGEMENT (PEM)

The government budget should be a financial mirror of society's economic and social choices. To perform the roles assigned to it by the people, the state needs to (i) collect sufficient resources from the economy in an appropriate manner; and (ii) allocate and use those resources responsively, efficiently, and effectively.¹ Hence, one should always keep in mind the integral relationship between revenue and expenditure—between the money collected directly or indirectly from the people (and, in most developing countries, from aid donors) and the use of that money in a manner that reflects most closely the people's preferences.² Also, close cooperation between tax and budget officials is a must for many areas, e.g., budget forecasting, macroeconomic framework formulation, and trade-offs between outright expenditures and tax concessions.

The Three Key Objectives of PEM³

Public expenditure management, as a central instrument of policy, must pursue all three overall economic policy goals of economic growth, stability, and equity. Financial stability calls for fiscal discipline; economic growth and equity are pursued partly through allocating public money to the various sectors; and, most obviously, all three goals require efficient and effective use of resources in practice. Hence, the three goals of overall policy translate into three key objectives of good PEM: fiscal discipline (expenditure control); allocation of resources consistent with policy priorities (strategic allocation); and good operational management.⁴ In turn, good operational management calls for both efficiency (minimizing cost per unit of output) and effectiveness (achieving the outcome for which the output is intended). But in addition, as stressed earlier, attention to proper norms and due process is essential as well.

There are linkages between the three key objectives of PEM, their corresponding major function, and the government level at which they are mostly operative. Fiscal discipline requires control at the aggregate level; strategic resource allocation requires good programming, which entails appropriate cabinet-level and interministerial arrangements; and operational management is largely an intraministerial affair. It should be stressed, however, that fiscal discipline and operational management are more amenable to technical improvement than is the strategic allocation of resources. Therefore, the allocation of resources is partly influenced by the organizational arrangement of central government discussed in Chapter 3. As Petrei (1998) puts it

Resource distribution among programs is perhaps the least technical part of the budget process. With the exception of investment projects, spending decisions are rarely based on technical principles or on detailed work to determine the population's preference. The allocation of funds results from a series of forces that converge at different points of the decision-making process, with an arbitrator who rules according to an imperfect perception of present and future political realities. The ministries, the headquarters of the principal agencies, and many other decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want. In any event, the effort made at this stage of the budget process to collect and analyze information is less than at any other stage.

The focus on public expenditure management should not lead to forgetting the essential link between revenue and expenditure. The triad of PEM objectives can easily be expanded into a triad of *fiscal* objectives. Fiscal discipline results from good forecasts of revenue as well as expenditure; strategic allocation has a counterpart in the tax incidence across different sectors; and tax administration, of course, is the revenue aspect of good operational management of expenditure.

Table 7.1 summarizes these relationships.

Objective	Revenue Function	Expenditure Function	Organizational Level
Fiscal Discipline	<i>Reliable forecasts</i>	<i>Expenditure control</i>	<i>Aggregate</i>
Resource Allocation and Mobilization	<i>Tax equity and incidence</i>	<i>Expenditure programming</i>	<i>Interministerial</i>
Operational Efficiency <i>Economy Efficiency Effectiveness Due Process</i>	<i>Tax administration</i>	<i>Management</i>	<i>Intraministerial</i>

This scheme is a simplification intended to help fix the key concepts in one's mind. The reality is more complex. First, as noted, the three objectives may be mutually conflicting in the short run (and trade-offs and reconciliations must be made) but are clearly complementary in the long run. For example, mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. Second, good aggregate budgetary outcomes must emerge from good outcomes at each level of government. For example, while fiscal discipline must ultimately be manifested at the aggregate level, it should emerge as the sum total of good expenditure control (and reliable revenue forecasts) in each ministry and agency of government, rather than being imposed top-down. (Chapter 2 discusses the importance of interministerial coordination.)

Therefore, an overall expenditure constraint is necessary but not sufficient for good PEM; on the contrary, imposing the constraint *only* from the top may result in misallocation of resources and inefficient operations. Typically, such top-down aggregate limits are intended to root out waste, fraud, and corruption. But waste, fraud, and corruption are hardy weeds. If the top-down limit is imposed *in isolation* and without any attention to the internal workings of the public expenditure system, the outcome may well be to underfund the more efficient and worthwhile activities, precisely because they do not carry benefits for the individual bureaucrats and their private partners.⁵ Conversely, it is not likely that internal systems can be improved without a hard constraint. Similarly, the best mechanisms for interministerial coordination are worth little if the sectoral expenditure programs are inappropriate or inconsistent with overall policy. Finally, management and operational efficiency cannot normally be improved except in an overall context of fiscal discipline and sound allocation of resources—to which good management itself makes a key contribution.

A Word about Sequencing

If you cannot control the money, you cannot allocate it, and if you cannot allocate it you cannot manage it. Fiscal discipline in many ways comes first; resource allocation and operational efficiency come next. This is literally true in those few developing countries that have extremely weak revenue forecasts and cash management systems. In those countries, the objective of improving expenditure control is first and foremost, and any effort at addressing the other two objectives of PEM would be futile and possibly counterproductive. However, it is essential to (i) design and implement improvements in expenditure control in ways that do not jeopardize the improvements in sectoral allocation and resource management that must eventually follow; and (ii) have a clear *ex-ante* sense of how far to push improvements in expenditure and cash control before addressing strategic allocation and management issues becomes timely and necessary.

In countries where expenditure control and cash management are already minimally acceptable, none of the three PEM objectives of expenditure control, resource allocation, and good operational management should be pursued in isolation from the others (just as the overall policy goals of growth, stability, and equity are interrelated). Improvements in one or another area can and should go forward as and when circumstances permit. But a coherent vision of the entire reform process is needed to prevent progress in any one objective from getting so far out of line as to compromise

progress in the other two, and thus the public expenditure management reform process in its entirety. Hence, a multiyear perspective is essential for good PEM. Specific reform priorities and sequencing considerations for each of the major components of PEM are suggested in the last section of this chapter.

Fiscal Transparency

Neither accountability nor good PEM can be achieved without access to reliable information by all major actors and the public. Box 7.1 summarizes some of the requirements for fiscal transparency, selected from the fiscal transparency code developed by the International Monetary Fund (IMF).

Box 7.1 Selected Requirements for Fiscal Transparency

Clarity of roles and responsibilities

- A budget law or administrative framework, covering budgetary as well as extrabudgetary activities and specifying fiscal management responsibilities, should be in place.
- Taxation should be subject to the law, and the administrative application of tax laws should be subject to procedural safeguards.

Public availability of information

- Extrabudgetary activities should be covered in budget documents and accounting reports.
- Original and revised budget estimates for the two years preceding the budget should be included in budget documents.
- The level and composition of central government debt should be reported annually, with a lag of no more than six months.

Open budget preparation, execution, and reporting

- A fiscal and economic outlook paper should be presented with the budget, including a statement of fiscal policy objectives and priorities, and the macroeconomic forecasts on which the budget is based.
- A statement of fiscal risks should be presented with the budget documents.
- All general government activities should be covered by the budget and accounts classification.
- The overall fiscal balance should be reported in budget documents, with an analytical table showing its derivation from budget estimates.

continued on next page

Box 7.1 (cont'd.)

Independent assurances of integrity

- Final central government accounts should reflect high standards, and should be audited by an independent external auditor.
- Mechanisms should be in place to ensure that external audit findings are reported to the legislature and that remedial action is taken.
- Standards of external audit practice should be consistent with international standards.
- Working methods and assumptions used in producing macroeconomic forecasts should be made publicly available.

Source: International Monetary Fund. 1998. Draft Manual on Fiscal Transparency. Washington, DC

THE BUDGET CYCLE: A BIRD'S EYE VIEW

This section summarizes the entire PEM cycle. Throughout the section we shall use the term ministry of finance to indicate the central government entity in charge of public expenditure.

The Budget and Its Preparation

Budget coverage

As explained in the appendix to Chapter 1, the general government consists of the central government and subnational levels of government, and the public sector includes the general government and all entities that it controls (e.g., state-owned enterprises). It is important for each level of government and public sector entity to have its own budget. For accountability and financial control, financial reports should consolidate the operations of the general government and (to the extent possible) the financial activities of all entities controlled by the government.

The coverage of the budget should be comprehensive. The budget should include all revenues and all expenditures of the government, whatever the arrangements may be for managing separately some particular programs, the legal provisions for authorizing expenditures, and the financing source.

Operational efficiency requires taking into account the specific characteristics of different expenditure programs when designing budget

management rules, e.g., rules concerning transfers of resources for one budget item to another. When there is a strong link between revenue and benefit, earmarking arrangements may be considered to improve performance in public services delivery; otherwise, such arrangements should be avoided.

Special management arrangements should not be allowed to hamper expenditure control and efficiency in resource allocation. Hence, extrabudgetary funds, special accounts, expenditures financed by external sources, etc., may need separate administrative arrangements but should be submitted to the same scrutiny as other expenditures. For this, they should follow the same expenditure classification system as other expenditure programs. Also, their related transactions should be recorded in gross terms, without “netting out” receipts and expenditures. For efficiency and anti-corruption reasons, it is necessary to know the magnitude of the receipts and the expenditures made from them.

In addition to direct spending, all policy commitments and decisions that have an immediate or future fiscal impact, or generate fiscal risks for the government, should be disclosed and scrutinized together with direct spending (tax expenditures, contingent liabilities, government loans, and quasi-fiscal expenditures).

Budget preparation

In keeping with the three key objectives of PEM, the budget preparation process should aim at (i) ensuring that the budget fits macroeconomic policies and resource constraints; (ii) allocating resources in conformity with government policies; and (iii) providing conditions for good operational management. Hard choices and trade-offs between expenditure programs must be made explicit when formulating the budget. Postponing such decisions until budget execution does not make them any easier, prevents the smooth implementation of priority programs, and disrupts program management.

Because the budget should be the financial expression of government policies, mechanisms for formulating sound policies and ensuring the policy-budget link are essential. These include

- coordination mechanisms for policy formulation within the government (Chapter 2);

- consultations with civil society (Chapter 14);
- adequate means for legislative review of policies and the budget; and
- regulations to reinforce the budget-policy link, notably (i) systematic review of the resource implications of a policy proposal; (ii) supremacy of the budget over other regulations on fiscal issues; and (iii) specific powers of the legislature in budgetary matters.

A medium-term macroeconomic framework should be the starting point of budget preparation. The degree of sophistication of macroeconomic projections depends on technical capacities within the country, but every country should prepare its budget within a macroeconomic framework based on realistic assumptions, without overestimating revenues or underestimating compulsory expenditures. To commit the government explicitly and to ensure public accountability, the fiscal targets and macroeconomic projections should be published in a user friendly format.

Financial constraints must be built into the expenditure programming process, to prevent the problems arising from open-ended approaches (i.e., excessive bargaining) and avoidance of necessary choices. Annual budget preparation (as well as any expenditure program) should be organized as follows:

- a *top-down approach*, which consists of (i) defining aggregate resources available for public spending over the planned period (within a sound macroeconomic framework); (ii) establishing sectoral spending limits that fit government priorities; and (iii) notifying line ministries of these spending limits early in the budget process;
- a *bottom-up approach*, which consists of formulating and costing sectoral spending programs for the planned period within the given sectoral spending limits; and
- *iteration*, negotiation, and reconciliation mechanisms to ensure overall consistency between expenditure aims and resource availability.

Budget preparation can be broken down in the following specific activities: (i) preparing macroeconomic framework; (ii) preparing a budget circular, which gives expenditure ceilings by sector and guidelines to spending agencies for preparing sector budgets; (iii) preparing of the line ministries'

budget on the basis of these guidelines; (iv) budgetary negotiation between the line ministries and the ministry of finance; (v) finalizing the draft budget; and (vi) submitting the draft budget to the legislature. All countries should adopt some appropriate medium-term budgeting perspective, consistent with the medium-term macroeconomic framework, and countries where conditions are conducive should consider implementing a formal multiyear expenditure programming approach.

To choose among expenditure programs and to plan for their implementation, spending agencies need to know the amount of resources allocated to their sector. Since they are accountable for sectoral policy and performance, line ministries should be responsible for preparing their sector budgets within those limits. The core ministries of finance and planning should facilitate and encourage that responsibility, and not usurp sectoral choices to themselves.

Weaknesses in the budgeting process depend in large part on political factors and on the organization of the government, e.g., lack of coordination within the cabinet, unclear lines of accountability, and overlaps in the distribution of responsibility (see Chapters 2 and 3). Mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires improvements in the following directions.

- Decisions that have a fiscal impact (notably, tax expenditures, lending, and guarantees and other contingent liabilities) should be scrutinized together with direct expenditure programs.
- Spending limits must be built into the start of the budget formulation process, consistent with policy priorities and resource availability. Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget preparation process.
- Policy coordination mechanisms that fit the country context are needed, with particular attention to the budget-policy link. The medium-term fiscal impact of policy decisions must be systematically assessed.

- Operational efficiency requires making line ministries accountable for implementing their programs. However, they can be held accountable only if they have participated in designing the programs and have authority for managing them. This requires, in a number of countries, reviewing and revising the distribution of responsibilities in budget preparation.
- Aid-dependent countries need to pay more attention to programming expenditures financed by external aid and should scrutinize their budget as a whole, regardless of the source of financing and despite the fact that the project approach adopted by donors may favor fragmentation in budgeting.

Implementing new policies and making shifts in the composition of expenditure take time. In the short term, most expenditures are fixed. Thus, assessments of forward costs, including the recurrent costs of investment projects, are required when preparing the budget, and the total costs of investment projects of a significant size (and their implementation schedule) should be reviewed when preparing the budget and shown in the budget documents or in annexes to the budget.

Rolling multiyear expenditure programs contribute to improving budget preparation, mainly by facilitating the setting of the ceilings that should frame the preparation of the annual budget, and by increasing predictability in sector management and efficiency in public spending. A formal and detailed program covering all sectors has recently become known under the medium-term expenditure framework (MTEF), but less demanding approaches to a multiyear perspective can be adopted. As discussed later, these are a multiyear program of investment expenditure across all sectors (public investment program or PIP) and a multiyear program of all expenditure in a single sector (sector expenditure program or SEP).

To avoid undesirable outcomes and perverse effects, the following principles should be adopted in multiyear expenditure programming.

- Multiyear expenditure estimates can be indicative for the out-years but must be fully consistent with the budget in their first program year.
- Whatever their coverage, multiyear programs must be framed by a multiyear macroeconomic framework, including estimates of aggregate

expenditures by function and by broad economic category (wages, other goods and services, transfers, interests, and investments). This requirement applies not only to comprehensive MTEFs, but also to multiyear approaches with a partial coverage (PIPs).

- Multiyear programs should not be used as an excuse for increased claims from spending agencies. Rather, they should focus on the forward impact of policy decisions to be made in the annual budget under preparation, and exclude new programs that are not funded with certainty. Therefore, the total costs identified in the multiyear programs should be less than the projected revenues from all sources.
- The process of preparing multiyear programs should be analogous to the budget preparation process. In particular, such programs should be prepared within the framework of annual expenditure ceilings.
- Depending largely on the country's administrative capacity, multiyear expenditure programs may vary in status (e.g., internal management document or published and official document), coverage (some sectors or programs only, or investment only, or MTEF with aggregate or detailed coverage), and degree of detail (as detailed as the budget or with a more aggregate presentation).

Organizational issues

The responsibilities of the different actors involved in budget preparation and policy formulation must be clearly defined and delimited.

- The center of the government (prime minister's or president's office, etc.) coordinates policy formulation and arbitrates any conflict that may appear in budget preparation. (See Chapter 2 for a coverage of these issues.)
- The ministry of finance sets the guidelines for budget preparation, scrutinizes budget requests, and ensures the coordination of the budget preparation process, as well as the overall consistency of the budget with policy and macroeconomic objectives.
- Line ministries and agencies are responsible for preparing their sector programs and budgets, within the policy directions and spending limits decided by the government.

As explained in detail in Chapter 8, assigning of expenditures to subnational government should be clearly made, and arrangements for revenue allocation should follow expenditure assignment. The central government should avoid downloading its fiscal problems onto subnational governments. Accordingly, increased expenditure assignments must be balanced by compensatory measures on the revenue side. Certain mandates of overriding national significance may not specifically carry additional resources, but should be the exception to the rule.

The legislature has a key role in reviewing and approving the budget. For this, adequate capacity and resources are needed. However, to achieve the three key objectives of fiscal discipline, resource allocation, and good operational management, certain limits are normally set on the amending power of the legislature.

Budget Execution

It is possible to execute badly a well-prepared budget; it is not possible to execute well a badly prepared budget. However, good budget execution requires more than simply assuring compliance with the initial budget. It must also adapt to intervening changes, and enable good operational management. Control procedures are needed, but should not hamper efficiency or lead to altering the internal composition of the budget, and must focus on the essential while giving spending agencies flexibility to implement their programs.

Assuring compliance: expenditure control

The budget system should assure effective expenditure control. In addition to a realistic budget to begin with, a good budget execution system should have the following:

- a complete budgetary appropriation accounting system, to track transactions at each stage of the expenditure cycle (commitment, verification, and payment) and movements between appropriations or budget items (apportionment, virements, and supplementary estimates);
- effective controls at each stage of the expenditure cycle, whatever their form and organization;

- a system for managing multi-year contracts and forward commitments;
- a personnel management system, which should include staff ceilings in countries undertaking civil service reform.
- Adequate and transparent procedures for competitive procurement and systems for managing procurement and contracting out.

Budget implementation

In implementing a well-prepared budget, allocative and operational efficiency calls for the following principles.

- Budget funds should be released on time.
- Cash rationing should be avoided (except in emergencies). A cash plan must be prepared, but should be based on budget estimates and take into account existing commitments.
- Supplementary estimates must be strictly regulated and their number limited.
- Virements (transfers between items) are justified, but should not lead to altering the priorities established in the budget. Rules for virements should be set up to allow for both management flexibility and control of the major items.
- Internal controls (within line ministries) are generally preferable to ex-ante controls performed by central agencies, but internal controls demand a strong monitoring and auditing system. Commitments and verification controls should be internal, to avoid excessive interference by central agencies in budget management.
- When payment processing and accounting controls are decentralized, central control of cash is required. When payment processing and accounting controls are centralized, a system is needed to assure that payments are made on time and according to the budget and the cash plan, without the central agencies superimposing their priorities. Advances in information technology should allow the government to reconcile the need to decentralize controls for efficiency reasons with the need to assure central control of expenditure.

- Some carryover of appropriations to the following fiscal year should be authorized, at least for capital expenditures, but needs to be regulated.

Cash management and the treasury function

Cash management is carried out to achieve the following: to control total spending, to implement the budget efficiently, to minimize the cost of government borrowing, and to maximize return on government deposits and financial investments. The following are key principles of cash management:

- Centralized cash balances (not to be confused with centralization of payments) is best made through a “treasury single account,” although advances in informatics make several treasury accounts feasible. A treasury single account is an account (or a set of linked accounts) through which all government payment transactions are made. It should have at least the following features: (i) daily centralization of the cash balance (when possible); (ii) accounts open under the responsibility of the treasury; and (iii) all transactions recorded in these accounts along the same classification. This model could fit both centralized and decentralized arrangements in PEM, provided that modern information technology is available.
- Cash planning includes (i) preparing an annual budget implementation plan, which should be rolled over quarterly; (ii) within this annual budget implementation plan, preparing monthly cash and borrowing plans; and (iii) weekly review of the implementation of the monthly cash plan. In turn, in preparing monthly cash plans, commitments must be monitored so that arrears or delays in payment are avoided.
- A borrowing policy is set in advance and a borrowing plan is made public. Borrowing by subnational governments must be regulated and should be consistent with overall fiscal targets.
- When contracting external debt, compliance with the budget or multiyear expenditure program should be monitored closely.

The Technical Infrastructure

Accounting

Good accounting and reporting systems are crucial for public expenditure management, accountability, and policy making. Accounting systems are classified as follows.

- *Cash accounting*, which focuses on cash flows and cash balances. Cash accounting is adequate for the objective of expenditure control, provided that it is complemented by an adequate system for registering commitments and reporting on expenditure arrears, or a false picture of the fiscal situation will result.
- *Modified cash accounting*, which adds to cash accounting a complementary period for recognizing year-end payments. (However, this system is normally cumbersome and risky as it may lead to corruption, and should be avoided.)
- *Modified accrual accounting*, which covers, in addition to cash, liabilities and financial assets. Modified accrual accounting gives a complete framework for registering liabilities and all expenditures.
- *Full accrual accounting*, which covers all liabilities and all assets. Accrual accounting, which is used in commercial enterprises, gives an appropriate framework for assessing full costs and performance. However, its requirements of review of data, and technical and administrative implementation capacity are heavy, making it unsuitable for most developing countries and very unreliable if inappropriately or prematurely introduced.

Whatever the basis of accounting, the accounting system should have the following basic features:

- adequate procedures for bookkeeping, systematic recording of transactions, adequate security system, systematic comparison with banking statements;
- use of the same methodology in recording all expenditure and revenue transactions into the accounts (including expenditures from funds and autonomous agencies, and aid-financed expenditures);

- common classification of expenditure along functional and economic categories;
- clear accounting and well-documented procedures;
- regularly produced statements (see “Reporting” below);
- systems for tracking the uses of appropriations (budgetary accounting) at each stage of the expenditure cycle (commitment, verification, and payment);
- clear procedures and full disclosure of budget financing operations (below-the-line transactions) and liabilities; and
- clear arrangements for the retention, access, and security of supporting documents, including computerized records.

Reporting

The reporting system must be designed to fit the needs of the different users (the legislature, the public, budget managers, policy decision makers, etc.). Minimum reporting requirements are

- budget management reports, showing all movements in appropriations and line items (allotments, supplementary estimates, transfer of expenditure between items, etc.);
- accountability reports to the legislature;
- financial reports (consolidated accounts of the general government, statement on arrears, report on debt and contingent liabilities, and report on lending); and
- budget policy assessment reports and line agencies’ reports.

Management control, audit, and evaluation

Management controls (also called “internal controls”) are the policies and procedures put in place by the managers of an entity to ensure its proper and effective operation. There are many kinds of management controls. Developing an effective system of controls requires, first, a careful

assessment of the risks facing the organization. Policies and procedures can then be selected to control those risks effectively and at reasonable cost.

Management controls are a basic responsibility of any manager. To be effective, the management control system must have the strong support of the entity's leadership. Policies and procedures must be observed consistently throughout the organization. Irregularities revealed by the control system must bring prompt and effective corrective action. To assure the continued effectiveness of the system, both the risks facing the organization and the control system itself must be reassessed frequently.

No system of controls can provide an absolute guarantee against the occurrence of fraud, abuse, inefficiency, and human error. However, a well-designed system of controls can give reasonable assurance that significant irregularities will be detected. At the same time, even well-designed controls can be defeated by collusion, especially if that collusion involves senior executives who have the power to disarm or bypass the control system. As stressed in Chapter 13, effective accountability requires appropriate external feedback and "voice."

Internal audit is part of an organization's management control structure. Lower-level units are audited by the internal audit office on behalf of top management. Among its most important functions, internal audit tests the management controls themselves and assists senior management in assessing risks and in developing more cost-effective controls.

External audit of government operations is typically performed by a supreme audit institution (SAI), which usually is independent of the executive branch of government and reports its findings to the legislature, the public, or both, as well as to the audited entity itself. SAIs may perform several types of audits, including ex-ante audits, compliance/regularity audits, financial (assurance) audits, and value-for-money (efficiency) audits. The appropriate audit emphasis depends on the particular circumstances of each country. Weak management controls and internal audit may require extensive ex-ante or compliance/regularity audit of individual transactions by the SAI. However, this is an inefficient use of audit resources. An SAI in these circumstance should work with the legislature and the ministry of finance to implement a coherent strategy for building effective systems of management control. Internal and external audits are complementary, not substitutes.

The credibility of external audit requires that the SAI and its staff be independent of the government units being audited, and have unrestricted access to required information. This independence is typically set forth in the legal provisions establishing the SAI. The SAI must guard this independence zealously, but, at the same time, its effectiveness depends on maintaining a professional, cooperative relationship with the legislature, the government, and the entities being audited.

There are several organizational models designed to reinforce the independence of the SAI, while also providing for its effective management as an organization. Most are variations of the “office” model, headed by an auditor general reporting to the legislature (typical of commonwealth countries) or of the “court” model, in which the auditors have the status of law court judges (as in France and Italy). Combinations of these two basic models are also seen in some countries.

To be effective, the SAI’s audit staff must have the professional skills required for the audits being performed. For an SAI to move from *ex-ante* and regularity audits to financial assurance and value-for-money audits, its present staff will have to be extensively trained in these more complex audits, or new professional staff will have to be hired. The cost-effectiveness of value-for-money audits must be demonstrated. In any case, strong compliance and financial audits come first.

The SAI, especially one pursuing strategic objectives such as improved management controls or undertaking more advanced types of audits, needs an effective means of communicating audit results and a sound approach for encouraging appropriate corrective action. No audit, however thorough, can provide absolute assurance of detecting every irregularity. An audit can give only reasonable assurance that any material errors will be found and reported. But even this level of assurance can be given only if the auditors have access to all needed records and the audit conforms to generally accepted auditing standards.

Program evaluation is a systematic effort to identify and measure the effects of government policies and programs. The more sophisticated forms of evaluation—experimental design and time-series analysis—involve the collection and statistical analysis of large volumes of data to isolate reliably the effects of the program from other factors that might have caused these effects (impact evaluation). Case studies provide less reliable information about causes and effects but have proven useful in identifying ways of improving efficiency.

For an evaluation to be useful, there must be clear agreement on the matter being examined and the data required to provide a reliable answer. Those performing the evaluation must have the professional skills and resources needed to collect and analyze the data. The evaluator must often depend heavily on the cooperation of operating units to gain needed access and to collect needed data. Program evaluation itself, like value-for-money audit, must show that it is cost-effective relative to the improvements identified or the progress expected.

Implementing a multiyear perspective

As emphasized earlier, a multiyear perspective is important for good budgeting. Such a perspective can be introduced in a variety of ways. The most comprehensive and detailed approach is frequently referred to as MTEF, which is a whole-of-government framework including all government expenditure at a high level of disaggregation. Such a full-fledged framework has heavy data and implementation requirements, and in many developing countries can be wasteful or even counterproductive if introduced prematurely or implemented badly. Fortunately, partial approaches to the necessary multiyear perspective exist and can be considered, especially in developing countries. However, in addition to improving the budget process in the short term, such partial approaches should be designed to help build the local capacity needed for eventually introducing more comprehensive multiyear expenditure programming.

The main points relevant to a comprehensive multiyear perspective in budgeting were made earlier when discussing budget preparation. The main points relevant to the partial approaches are summarized here. The two main partial approaches to medium-term programming are one that incorporates all government expenditure in a particular sector, and one that incorporates all expenditure in a major expenditure category.

The former approach is comparatively recent, and has become known as the SEP. The key points applicable to multiyear programming are also relevant to SEPs. However, because it covers only one sector, an SEP must be prepared under a stringent financial constraint flowing from the macroeconomic framework. Otherwise, this partial route to a multiyear perspective is likely to introduce a “needs” mentality, with all the problems such a mentality causes for PEM, or merely provide a “pet sector” for aid donors, with ensuing distortions in strategic resource allocation.

The latter approach is normally applied to investments, and has been common in aid-dependent developing countries under the PIP. PIPs emerged in the early 1980s as a reaction to the rigidities of the fixed development plans of the 1970s, and as a means to improve the programming of external aid, most of which is given for investment. PIPs are on a rolling basis and cover a three- to four-year period. When badly prepared and implemented, PIPs become wish lists of projects or shopping lists for donor monies, and can harm the expenditure management process. However, like a good SEP, a well-prepared PIP can improve the process as well as strengthen the recipient country's control over foreign aid. Ideally, a strong PIP should do the following.

- Include only economically sound investment projects that are clearly related to government policy. (For the out-years, the evaluation of projects may be indicative, but projects must always meet the “double sense” criterion of “development sense” and “common sense” before they are included in any form for any year.) Procedures to prevent the birth of “white elephant” projects are especially important.
- Cover all central government investment as well as investments by other public entities that are financed by the central government.
- Stay strictly within the ceilings set by the macroeconomic framework (although, according to the iterative nature of macroeconomic programming, public investment should never be defined as a mere residual derived from the other fiscal and macroeconomic targets).
- Include in the first year only projects for which financing is *certain*.
- Assure that adequate complementary local funding is included in the annual budget. “Counterpart funding” problems are likely in any event, but are a certainty if the aggregate budgetary provision for investment is insufficient.
- Include in the out-years only projects for which a firm decision has been made and financing is highly probable. (In effect, the PIP would then comprise only “ongoing policies,” as recommended for multiyear programming in general.)
- Prevent overreliance on external expertise, and foster systematic improvements in local capacity. This may well be the most important

requirement. External expertise may be needed. However, if the PIP process inadvertently becomes a mechanism for replacing local responsibility with expatriate experts, it will neither improve the budget process nor contribute to local capacity. This risk, of course, exists in aid-dependent countries whether or not they have a PIP process.

Aid management

In aid-dependent developing countries, all three objectives of government expenditure management require that the recipient government and not the donors should “drive” the allocation and use of aid funds—while respecting, of course, the procedural and fiduciary requirements of the donors concerned. Experience worldwide shows that there are several requirements for effective aid management.

- External resources must be integrated with overall resource use, and thus included in the budget.
- There should be one, and only one, aid management entity (preferably in the ministry of finance) covering all external aid, including technical assistance.
- Aid management should be structured along donor lines (e.g., an Asian Development Bank desk, a World Bank desk, etc.) rather than sectoral lines (e.g., a health assistance desk).
- The aid management entity should facilitate, not obstruct, and avoid interfering in ministries’ budget proposals or project selection.

KEY POINTS AND DIRECTIONS OF IMPROVEMENT

Key Points

Although public expenditure management is separate from tax and customs administration, good expenditure management is very difficult without reliable forecasts of revenue as a starting point.

The management of central government expenditure has three key *objectives* and one requirement for sustainability. The three objectives are expenditure control, allocation of resources in conformity with policy priorities, and good operational management. These objectives may be mutually conflicting in the short run but are complementary in the long run, provided that the requirement for sustainability is also met. This

requirement is that the budgeting system must abide by due process and meet the criteria of good governance, including transparency.

Because the budget should be the financial mirror of government policies, its coverage must be comprehensive (including all revenues and expenditure, whether financed locally or through foreign aid, and using the same classification for all expenditure categories), and it must disclose all decisions that have a fiscal impact (e.g., loans) or carry a fiscal risk (e.g., loan guarantees).

The *preparation of the budget* should start with a top-down approach, whereby a medium-term macroeconomic framework allows the definition of the initial spending ceilings—both for overall expenditure and expenditure for each sector. Next is a bottom-up stage, in which the ministries and agencies formulate their spending programs consistent with both the policy priorities and the spending ceilings. The budget is then finalized through a process of iteration and negotiation between the ministry of finance and the spending agencies. Without a hard spending ceiling to begin the process, the budget preparation turns into a list of sectoral needs, which are then difficult to reconcile with overall available resources. But, conversely, without iteration and negotiation to ensure overall consistency between aims and availability, overall fiscal discipline may be achieved at the cost of good sectoral allocation and sound operational management.

It is also important to frame the annual budget within a multiyear perspective, both because expenditure flexibility is very limited on a year-by-year basis while changes in policies require significant reallocation of resources, and because of the need to assess the future costs of today's decisions (especially public investment decisions). Partial multiyear approaches may be useful in moving toward a comprehensive multiyear perspective (MTEF). An SEP is a multiyear program comprising all expenditure for one sector; a PIP is a multiyear program comprising one category of expenditure for all sectors.

Good *budget execution* begins with good budget preparation, but entails more than just assuring compliance of actual spending with the budgeted amounts. There must be mechanisms to adapt to intervening changes, and to achieve a balance between external control and operational flexibility needed by managers. In particular, among other things, budget funds should be released on time and in predictable amounts; transfers between budget items, and some carryover of expenditure to the following year should be

permitted but clearly regulated; and internal controls on commitments and verification should be complemented by a strong monitoring and audit system.

Among the *accounting* systems, cash accounting is the simplest, and is adequate for expenditure control; accrual accounting is the most comprehensive, and the most demanding to implement. Most countries find it appropriate to use *modified accrual accounting*, which covers, in addition to cash, liabilities and financial assets. Whatever the basis of accounting, good, clear, transparent, and reliable bookkeeping and reporting are a must.

Without strong external *audit*, the expenditure management cycle is incomplete and risky. An independent audit entity, external to the executive branch, is essential, and should be well staffed and with complete access to requisite information. However, its effectiveness depends on good management controls and internal audit within the spending entities themselves. Operational effectiveness and integrity cannot be achieved only by external scrutiny. Also, before expending resources and staff on audits of performance and efficiency, the basic audits of compliance and financial integrity must be strong and effective.

Directions of Improvement

The approach to improving central government budgeting should be pragmatic, providing a menu of options rather than single “best-practice” models. However, certain principles are universal:

- making sure that changes in PEM strengthen the four pillars of governance (accountability, transparency, predictability, and participation);
- using improvements in public expenditure management partly to reduce opportunities for corruption, both home-grown and imported;
- paying attention not only to fiscal discipline, but also to strategic resource allocation, good operational management, and due process; and
- stretching the horizon of budgeting beyond the immediate future, through a concrete multiyear approach, when feasible, but at a minimum at the level of systematic reflection and dialogue.

In addition to these general principles, experience suggests three practical rules for assessing the merits of recommendations to improve expenditure management in the specific country context.

- Getting the basics right is a must for the process of spending the people's money, especially in poor countries where the people can least afford costly experiments. In the words of the Conference on Fiscal Policy and Reform (2–4 February 1999, Apia, Samoa), “fundamental elements of budgeting preparation, implementation, and monitoring that permit effective control, promote transparency, foster accountability, and ensure legitimacy need to be firmly in place before highly sophisticated concepts of budget management...[are] introduced.”
- Any measure to improve public expenditure management in developing countries must raise the country's own capacity to manage its public expenditure. An improvement in public expenditure management designed and implemented primarily by expatriate specialists is no improvement at all; quite the contrary, it may even worsen matters. Neither can improvements last if they are imposed top-down by the central agency with little involvement or implementation capacity of the sector ministries.
- Assess the record of actual success or failure of the measure being recommended by independently obtaining feedback from other countries that have experimented with it.

On *budget preparation*, priority actions are a reasonably comprehensive budget coverage, disclosure of policies that have an immediate or future fiscal impact (e.g., contingent liabilities), and a good expenditure classification. In addition, efficient line-item cash budgeting must be established on a solid basis before considering a move to other budgeting systems.

Hard financial constraints, flowing from a consistent macroeconomic framework, are essential at the start of the budget preparation process, to give the line ministries the predictability needed to design their expenditure programs, in conformity with government sector policy. Good operational management requires that line ministries be accountable for implementing their programs, but they can be held accountable only if they have sufficient authority to design those programs.

To move toward a *multiyear budgeting perspective*, the first priority is to prepare aggregate expenditure estimates by function and broad economic category, and review the forward costs of programs when preparing the

budget. As the next stage, multiyear expenditure programs can be prepared, including only programs/projects for which financing is assured—thus focusing only on ongoing policies. As a final stage, a formal and detailed medium-term expenditure framework can be prepared, with the same coverage and degree of detail as the annual budget. To achieve this final goal, a progressive approach can be considered. Aid-dependent countries should first prepare a strong and realistic public investment program (consistent with available resources and without “white elephant” projects). Other countries could focus on other costly expenditure items, e.g., pensions and other entitlements. In addition, preparing a full sector expenditure program for one or two key sectors can yield useful experience in multiyear programming.

Improvements in *budget execution* generally entail enhanced expenditure control, more efficient spending, and better cash management. Improved expenditure control results mainly from timely and predictable release of funds; effective controls and monitoring at each stage of the expenditure cycle (commitment, verification, and payment); clear procedures for registering commitments; and, of course, sound and well-enforced procedures for procurement (discussed later). Improvements in efficiency call for flexible rules for virements; some possibility for carry-over of authorized spending to the next year; and progressive decentralization of controls, but in parallel with a reinforcement of audit and financial reporting. Finally, priority actions for better cash management include a realistic cash plan consistent with the budgeted expenditure; centralization of cash balances (not necessarily of actual payments); and timely tracking of government borrowings and repayments.

In *audit*, efficiency (value-for-money) audits may be considered only after a strong financial and compliance audit is clearly established, and all resources should be concentrated on that basic priority. Similarly, in *accounting* the priority is on establishing a solid cash accounting basis and consolidating the operations of extrabudgetary funds—complemented, however, by a commitment register, accrual accounting for debt, and the recording of contingent liabilities. Further improvements could include modified accrual accounting and the formulation of asset registers—at least for the more valuable assets at risk. A move to full accrual accounting should not be considered until the previous steps are firmly in place (except for public sector activities, where accrual accounting is essential). Finally, *performance orientation* in budgeting can be fostered in several ways other than the formal introduction of quantitative performance indicators or performance budgeting, as explained later.

NOTES

- ¹ As Chapter 1 explains in detail, efficiency relates to the concrete results of government activity, while effectiveness relates to achieving the intended purposes of those activities.
- ² In this book, we do not address the complex question of how the people's preference can be ascertained. We do underline, however, the bureaucratic as well as inherently political nature of the process of allocating public monies to various users and beneficiaries. Indeed, Kenneth Arrow proved mathematically almost 40 years ago the "impossibility" of aggregating individual preferences into a single social preference function that is stable, consistent with economic efficiency, and not dependent on coercion. See Arrow and Scitovsky (1969). Other contributions, known collectively as "public choice theory," look at the budget as being determined by a market-type medium, whereby "rational individuals converge in an effort to maximize their own satisfaction" (Petrei 1998).
- ³ These are often called levels (by Campos and Pradhan [1995], among others). However, the term can easily be misinterpreted as implying a logical sequence or a hierarchy among the three.
- ⁴ The latter two objectives of strategic resource allocation and good operational management are easily recognizable in the distinction traditionally made in economics between allocative efficiency and efficiency of use.
- ⁵ Petrei (1998, p. 338) concludes that in Latin America, "pressure to spend less has led to better spending in many cases, but in many others it has led to the opposite result."

Chapter 8

Managing Local Government Expenditure and Fiscal Decentralization

So long as we do not ensure that expenditure of money upon local objects conforms with the needs and wishes of the locality, invest it with adequate power and assign to it appropriate finances, we will never be able to evoke local interest and excite local initiative.

—Balwantray Mehta, 1959

DISTRIBUTION OF FISCAL RESPONSIBILITIES BETWEEN CENTRAL AND LOCAL GOVERNMENT

As mentioned in Chapter 7, each government level (central, provincial, municipal, etc.) should have its own budget, enacted according to constitutional provisions or law. However, there are strong links between the budget of the central government and the budgets of subnational governments that require particular attention.

“Fiscal Federalism”: Key Issues

The degree of devolution, assignment of expenditures, and revenue arrangements should be tailored to the country context and depend on policy and political issues, as has been pointed out earlier. However, certain key principles should govern these arrangements in any country. Chapter 5 explained the efficiency approach to decentralization. It is embodied in Oates’ decentralization theorem, which states that each public service should be provided by the jurisdiction that controls the smallest geographic area that would internalize the benefits and costs of such provision. This is a pretty tough test to devise and meet in practice. The European Union has adopted a more operational approach in the principle of subsidiarity for assigning responsibilities among its members. According to this principle, taxing, spending, and regulatory functions should be exercised by lower

levels of government unless a convincing case can be made for assigning them to higher levels of government.

The literature on fiscal federalism discusses the complexity of decentralization and gives hypothetical and real-life examples of expenditure assignments (Box 8.1).¹ The need for increased fiscal decentralization is generally admitted. Many observers, however, stress the risk of loss of expenditure control, increased corruption, and inefficiencies in resource allocation that would result from hasty fiscal decentralization, even when theoretically justified.²

Box 8.1

Fiscal Management in Federal Systems

In the 1980s, Argentina and Brazil faced similar problems, with subnational deficits added to excess public deficits and high inflation. In the 1990s, both countries continued with fiscal decentralization and with the struggle to bring about macroeconomic stability. Argentina had greater success, partly because it imposed a harder budget constraint on the public sector at the national level and had stronger party control of the subnational governments and of the national legislators. For restraining local and state borrowings, getting the right incentives for subnational governments and particularly for its creditors in Argentina proved more effective than central government rules in Brazil.

In the People's Republic of China, the implementation of the Budget Law in 1994 strengthened the basis for fiscal operations. Central approval of local budgets was abolished and budgetary procedures were clarified, requiring the local and central budgets to be formulated in a consistent macroeconomic framework. Local governments were disallowed from financing any deficits through bond issues, bank borrowing, or grants from the central government. They were required to run balanced budgets or to use accumulated budgetary surpluses and extrabudgetary funds to finance deficits.

Sources: Dillinger, W. and S. Webb. 1999. Fiscal Management in Federal Democracies: Argentina and Brazil. World Bank; Ahmad, E., G. Quiang, and V. Tanzi, eds. 1995. Reforming China's Public Finances. International Monetary Fund (IMF).

Broad Principles of National-Local Financial Interaction

Whatever the degree of devolution appropriate to the country, the legal framework that governs the relationships between the central and local governments and the arrangements for budgeting must be clear and

efficient. However, it is impossible to provide for every situation in a codified law or contract. Conflict resolution mechanisms are therefore important to assure smooth intergovernmental fiscal relations. Such mechanisms can operate through specialized bodies. In Australia, India, and Sri Lanka, for example, a finance commission deals with financial relationships between the central government and the other levels of the government; in Germany, a second chamber of Parliament with state representation contributes to intergovernmental policy coordination; and specialized sectoral coordination councils are common in many countries.

The following principles are required for transparency and efficiency of national-local interaction.

- Each level of government should have clearly assigned responsibilities, regardless of what responsibilities are assigned to government as a whole (Box 8.2). Overlaps should generally be avoided, and long concurrent lists of shared responsibilities are particularly ambiguous.
- Fiscal and revenue-sharing arrangements between the central and local governments should be stable. They may be amended from time to time, but renewed bargaining each year should be avoided at all costs.
- Subnational governments need to have a sound estimate of these resources before preparing their budgets. In some countries (e.g., the Ukraine in 1996–1997), local governments had to wait for the draft budget of the central government to be finalized before preparing their own budgets. Such lack of predictability hampers both efficiency and fiscal control at the local level. Without an indication of the amount of resources to be transferred to them, subnational governments cannot program their expenditures. Accordingly, forecasts of revenues should be transmitted to local governments as soon as they are set, and estimates of grants to local governments need to be prepared early in the budget process of the central government.
- Incentives for increased efficiency are needed. Often, the central government reduces transfers to subnational governments when they make economies in spending or improve their own tax collection. This evidently does not stimulate them to seek economies in service delivery or improve tax collection. Subnational governments must be allowed to benefit from savings they make, at least in large part.

The same argument applies with respect to the commercial revenue of state agencies.

- It could be desirable to agree on multiyear contracts between the central government and local governments covering both expenditure assignments and revenue arrangements (tax sharing, grants, etc.). These contracts could, if appropriate, include performance criteria, minimum standards for services rendered by local government, etc. They would define relationships in a transparent manner and would ensure predictability. As with any other contract, of course, the utility of this arrangement would depend largely on how well it is monitored and respected.
- National law should provide standard accounting and budgeting rules for subnational governments.

Box 8.2

Defining Expenditure Assignments of the People's Republic of China

To date, the People's Republic of China (PRC) has failed to work out a law that clearly defines expenditure responsibilities for different levels of government. Expenditure assignments are murky and often motivated by political expediency, shift between levels of government in ad hoc ways. The central government may shift its own expenditure responsibilities to provincial governments in times of difficulty and provincial governments may use their broader responsibilities to bargain for a larger share of revenue. Intergovernmental bargaining has weakened budgetary planning and control and contributed to the instability of the PRC's fiscal system. Without first deciding on expenditure assignment, the PRC authorities have found it difficult to reform tax assignment rules and revenue-sharing mechanisms between the central and provincial governments.

Expenditure assignments between the provincial government and lower-level authorities, such as municipalities and counties, are even more vague. Local governments are often forced to take the responsibility that should belong to higher-level government, accentuating the mismatch between local revenue and local expenditure responsibility. Unspecific and unpredictable, the system of expenditure assignments has created budgetary uncertainty for the central government and made fiscal planning an impossible task for provincial and local authorities, thus adversely affecting the quantity and quality of the public goods and services they supply.

Source: Ahmad, Qiang, and Tanzi, eds. 1995. Reforming China's Finances. Washington, DC: International Monitoring Fund.

For expenditure control and strategic allocation of resources

- Fiscal targets should cover the *general* government.
- Revenue assignment should be fully consistent with expenditure assignment, and sufficient resources should be assigned to subnational governments to allow them to fulfill their duties. When new duties or responsibilities are transferred to subnational governments, compensatory measures should be provided on the revenue side. On the other hand, of course, if some duties or responsibilities are removed, transfers to subnational government should be correspondingly reduced.
- Dumping of the fiscal deficit should not be permitted (defining fiscal targets for general government helps avoid this problem). When balancing its budget, the central government should avoid passing its financial problems to subnational governments through cuts in intergovernmental transfers or increased expenditure assignments, without compensatory measures. To do so would neither change the aggregate borrowing requirements of the general government, nor generate arrears.
- Special mechanisms are needed to control local government borrowing (see Box 8.3 for arrangements in various countries).
- In case of local government budget overruns or accumulation of arrears, the law should stipulate sanctions or emergency measures. For example, local authorities could be forced to cut expenditures or raise taxes, or local budgets could be placed under the authority of the central government for a limited time until the situation stabilizes. An exception should be explicitly provided for instances when the overrun or arrears are directly related to a dumping of central fiscal problems, as mentioned above.
- A sound reporting and accounting system is critical. Subnational government financial operations should be consolidated with central government operations. Systems for budget execution, internal control, and audit for subnational governments should be similar to those of the central government. This leads back to the central question of local government administrative capacity, and hence the issue of the desirable degree of decentralization.

Box 8.3

Arrangements for Controlling Borrowing by Subnational Governments

Country	Control Provisions
Argentina	The provinces may contract debt both internally and externally. The Central Bank oversees the impact on the financial system, and the Ministry of the Economy oversees maximum external interest rates.
Australia	The Australian Debt Council determines the total public debt and the distribution between the different government levels, but in practice market mechanisms operate.
Brazil	The Federal Senate sets overall limits on the amount of debt that states, the federal district, and the municipalities can contract, and establishes the rules and conditions for their external and internal credit operations.
Canada	No formal restrictions. Market mechanisms are in place.
Chile	Municipalities and state-owned enterprises can contract loans for special projects. But this requires a law that must also indicate how the loan is to be repaid.
Colombia	According to constitutional regulations, a local government may not borrow more than it can repay. There is a law that establishes graduated authorization procedures according to debt levels.
Mexico	The states may not in any case, directly or indirectly, contract obligations or loans with foreign governments, companies, or private parties, or loans that must be repaid in foreign currency. States and municipalities may contract loans only for productive public investments.
New Zealand	Generally speaking, local governments must finance current expenditures with revenues for the same year.
Sweden	A balanced budget is required. Local and municipal governments are responsible for their own debt.
United Kingdom	A balanced budget is required.
United States	All local governments must have a balanced budget. Most states have either a constitutional or a statutory requirement for a balanced budget.
Venezuela	Local and municipal entities may not contract loans without the authorization of federal authorities.

Sources: Ter-Minassian, ed. (1997); Petrei (1998).

- Consolidating the expenditure of the different levels of government is necessary also for policy analysis, especially in decentralized systems and federal countries. It would be very difficult to know what is being spent on key sectors if only the accounts of the central government were considered. For the purpose of consolidation, local and central governments should have a common functional and economic classification of expenditures.

FISCAL DECENTRALIZATION: BENEFITS AND PROBLEMS

Prerequisites for Fiscal Decentralization

Some key conditions must be in place for fiscal decentralization.

- Related to political decentralization, a subnational government entity should be responsible to the local population in some appropriate fashion (normally through elections).
- Chief local executives should be elected or appointed directly or indirectly by such a local government entity. It is difficult for the local government to implement its own programs if local executives are appointed or seconded by governments at a higher level, as is the case in many developing countries (Chapter 5).
- Local government must have some taxing powers of its own to have effective control over its budget. If all local government revenues are in the form of fiscal transfers from the central government, it is actually the central government that decides the local budget, impairing the essence of fiscal decentralization.
- Local governments must have adequate tax administration capacity. Poor tax collection defeats the advantage of having some revenue-raising powers.
- Local governments must have some degree of autonomy in determining their service levels before they can be made accountable for delivering services that are important to the local citizens.

Potential Benefits of Fiscal Decentralization³

Efficiency

Fiscal decentralization can increase service efficiency and people's economic welfare, as local governments can better suit the differing tastes and preferences of residents and are more responsive to the public. More efficient services will be provided, since people can hold local officials accountable for service delivery at some acceptable quantity, price, and quality.

Revenue mobilization

A decentralized tax structure may lead to more effective tax administration and hence, with the same overall tax rates, greater revenue. Central governments typically exclude potential small taxpayers from the tax net because of the administrative difficulties associated with identifying them, and because the revenue gains are relatively small compared with the administrative costs of collection. Local governments, being closer to the people, may reach the lost potential revenues through some kind of user charges and other minor taxes. This is particularly applicable to subnational governments in transitional economies where small private business is a rapidly growing sector.

Resource allocation and equity

Because local government is closer to the users, it is in a better position to decide on appropriate user charges for some services and administer the system, thus improving the allocation of resources and fostering economic growth, while tailoring charges to ability to pay.

Potential Costs of Fiscal Decentralization

The potential costs are an almost exact mirror image of the potential benefit argument. One of the other argument will be valid, depending on the specific country conditions and time.

Efficiency

The converse of the efficiency case for decentralization argues that fiscal decentralization can worsen efficiency when local bureaucracies are

unresponsive, technically and managerially deficient, and poorly motivated—as they are in many developing countries and several developed countries. Also, the assumption that people express their preferences through their votes is not always valid, considering local allegiances in many developing countries that reflect economic dependence, political loyalties, religious affiliation, cultural identities, etc., rather than public tastes and preferences for certain services and government efficiency.

Poor resource mobilization

The same negative effect on tax administration and resource allocation can occur when local capacity is limited. And local government may be more vulnerable to “capture” by powerful local elites. Any revenue gained by expanding the tax base to include small taxpayers can be more than offset by the loss of revenue from underpayment of tax by wealthy people.

Regional inequality

Fiscal decentralization fosters regional inequalities and may lead to unequal treatment of individuals, where persons or households with the same income but residing in different localities are treated differently because of dissimilar tax and expenditure policies of local governments. In decentralized allocation of public goods and services, taxes are collected and expenditures undertaken differently in different jurisdictions. Fiscal decentralization may heighten regional inequalities. Rich regions, with higher income from their larger tax bases, can lower tax rates and provide better public goods and services. The lower tax rates may induce mobile persons to settle in rich jurisdictions, further enlarging their tax bases and concentrating activities and growth in a few cities and localities; and the better public services (especially in education and health) will provide a continuing advantage for human capital formation, growth, and competitiveness. Thus, rich regions become richer and poor regions become poorer.

Resource allocation

Local governments may be unable to build to proper standards and adequately maintain infrastructure and services, primarily because of poor technical and managerial capacity. The case of Tunisia is instructive (Box 8.4). This resource allocation argument against fiscal decentralization is generally the weakest, however. (See Chapter 5 for a discussion of vertical coordination among different levels of government.)

Box 8.4
Decentralization in Tunisia: A Case Study

Until 1974, local governments in Tunisia were responsible for the collection and treatment of used water. However, the quantity and quality of the service were bad. For one, local governments had very little technical expertise. A survey of people employed in the sector revealed that only 4 percent of the total workforce had any skills related to sewerage. Local governments kept no accounting information on service costs and no form of cost recovery was available.

Moreover, most local governments did not invest in the necessary equipment and technology useful for the sector. In 1970, only 20 out of 150 municipalities reportedly had some form of treatment plants, and all of these were overloaded and malfunctioning. Many sewer systems were also either poorly designed or poorly maintained. Manholes, grit traps, and other sewer accessories were out of service. Of the 27 sample lift stations inspected in 1974, only five were functioning.

The implications were serious. The Lake of Tunis, into which used and poorly treated water was discharged, was rapidly deteriorating. Infectious and parasitic diseases such as cholera therefore became prevalent.

Instead of helping local governments improve their systems, the central government of Tunisia decided to take over the provision of service from the local governments. In 1974, the Office National de l'Assainissement (ONAS), a specialized semiautonomous agency, was created and was given a monopoly over the service. ONAS' management was autonomous, it was appropriately staffed, and sound financial procedures were instituted. At first, ONAS operated only in the Tunis metropolitan area, then it gradually covered all other major urban centers of the country. In other parts of Tunisia, municipalities that had their own system continued to operate them but were later integrated into ONAS' operations.

With the help of foreign institutions such as the World Bank, ONAS developed into an effective and efficient institution. By 1987, many of its staff had become competent technical professionals and had replaced the foreign assistants who had been temporarily hired. Service costs had been recovered and the level of sewerage services had increased significantly. By 1988, ONAS was providing full sewerage services to the 30 largest cities, comprising about 50 percent of the urban population of Tunisia.

Most reports consider the centralization of the Tunisian sewerage system a success in terms of production or supply efficiency. Although the financial and technical assistance of foreign institutions and donor agencies may be a big factor in this success, it is also true that the resources for improving the system would have been more difficult to mobilize in a decentralized system. Also, it would have been more difficult and costly to train personnel and improve the financial and accounting procedures of 30 municipalities instead of a single institution.

Source: Prud'homme (1994).

Implementing Fiscal Decentralization

Given the various options for decentralizing expenditure and revenue assignments, problems arise as to their implementation. The major ones are fiscal gaps and fiscal inequities. They are summarized below and discussed in detail in the next two major sections.

Fiscal gaps (vertical imbalances) are the result of inconsistent tax and expenditure assignments. Most major taxes are typically assigned to the central government, resulting in a fiscal gap for local governments with growing spending responsibilities. As argued earlier, the central government is also often tempted to adjust to fiscal difficulties by downloading expenditure responsibilities to local levels without the resources required to carry them out. The mismatch of expenditure and revenue assignments that leads to vertical imbalances also leads to fiscal inefficiency, as differences in levels of services between regions caused by differential fiscal gaps can distort business and investment decisions.

Fiscal inequities (horizontal imbalances) among subnational governments arise from revenue differences between local governments with different tax bases, different technical and administrative capabilities to collect taxes, or different costs and demand for local public services. A grant system may be used to equalize fiscal capacities among subnational governments so that citizens residing anywhere in a country will receive the same level of basic service (see below).

Normally, subnational governments will not have the incentive to provide services whose benefits extend beyond their boundaries, and will therefore tend to underprovide these services. Fiscal transfers can supplement incentives for subnational governments. However, in practice, the extent of spillovers is difficult to gauge, so the matching between transfers and the spillover rate will be somewhat arbitrary.

VERTICAL IMBALANCE: EXPENDITURE AND TAX ASSIGNMENT

Expenditure Assignment⁴

Chapter 5 discusses the principles governing the decision on which level of government should provide a particular public service. Generally, the main guiding principle is to assign each type of expenditure responsibility

to the level of government that would benefit only the residents that it represents. On the basis of this general principle of local benefit, purely local expenditure responsibilities should include water, sewer, waste, and fire protection services, while central expenditures should be those whose benefits extend nationwide. However, this principle is far easier to state than to apply. Most public goods and services do not fit neatly within either category. There are services whose delivery can be shared by the central and local governments, such as those with unclear benefit regions, externalities, or national redistributive implications. In such cases, different aspects of delivery of the same service—policy, financing, and actual administration—may be assigned to different levels of government.

The lack of guidelines for sharing responsibility for delivering a particular service (especially when it comes to social spending) has led to diverse practices in various countries. For example, pensions and unemployment benefits are generally a function of central government, but in the United States (US) they are provided by the state governments. The administration of social assistance is a function of local governments in a number of countries, but it is a function of central governments in others.

Public services can be assigned to local or regional governments based on considerations such as economies of scale, cost-benefit spillovers, proximity to beneficiaries, consumer preferences, and flexibility in choosing the composition of budgets for public spending. Generally, the following types of services are the responsibility of central government:

- services that are not differentiated by local demand, such as defense, justice, or international affairs;
- services that would benefit many jurisdictions and can be handled only by contracting or by grant design, such as public transport or air and water quality; and
- services whose local administrative costs significantly outweigh the local benefits, such as income tax collection.⁵

Note, however, that these services may still be administered locally even if the central government makes the policy and provides financing.

Tax Assignment

Revenue sharing

The tax assignment approach entails that subnational governments (i) choose the tax base, (ii) assess the tax base, (iii) decide the tax rate, (iv) collect the tax, and (v) retain the tax proceeds. Rarely are all these conditions met. Some local taxes might be really central grants to local governments, or a central tax and a related transfer program may actually be a local tax. For a tax to be truly local, subnational governments must have the power to both decide on the tax rate and receive the proceeds. Normally, the types of taxes assigned to local jurisdictions depend partly on the overall mix of taxes in the country as a whole.

It is generally recognized that assigning all or most taxing powers to subnational governments with upward revenue sharing is not advisable, since such an arrangement does not allow the central government to perform its redistributive and macroeconomic management roles. The arrangement is, however, carried out in a few countries like the People's Republic of China. Upward revenue sharing is also considered viable in loose confederations where stabilization and redistribution policies lie with the member states, as well as in countries where subnational jurisdictions have homogenous economic conditions and close tax policy coordination and harmonization. Examples are Germany and, of course, the member-states of the European Union.

On the other hand, assigning all taxing powers to the central government and relying entirely on downward transfers to local government is equally undesirable. The arrangement inhibits local governments from matching spending authority with revenue-raising power, hence reducing their fiscal accountability.

Some countries completely separate the tax bases for each level of subnational government, while others allow certain overlaps (Boxes 8.5 and 8.6). Tiers of government in Australia, India, and Germany, for example, have separate tax bases, while Canada and the US have a certain degree of overlap in their tax bases.

Box 8.5**Peculiarity of Local Financing in Transitional Economies**

Transitional economies, in many ways, may be considered less decentralized than most countries. However, recent developments show that fiscal decentralization is on the way. Typically, their approach to local financing is revenue sharing on a derivation basis. The system may be considered somewhat decentralized, since local governments decide how they will spend their respective shares.

There are indications that transitional economies are moving toward the revenue assignment approach. For example, although the central government of the People's Republic of China determines all tax rates and bases, subnational governments collect the revenues from all income taxes and earmark a piggyback on the value added tax for local use. Russia allows its regional governments the option of levying the company income tax at a lower or higher rate.

One peculiar feature of decentralization in transitional countries is the backdoor approach to local government financing. Local governments in these countries, constrained by the limited transfers they receive to finance large expenditure responsibilities, resort to extrabudgetary financing. This can easily be done since local governments, which are responsible for tax collection, still have ties with the enterprises and can therefore exonerate them from taxes. Hence, local governments are able to hive off resources from the sharing pool, resulting in greater retention of revenues at the local level.

Sources: Bahl (1998); Wong (1999).

Revenue sharing can be on a (i) derivation basis, where sharing is based on the source of tax proceeds; (ii) grant basis, where the central government distributes the revenues to all subnational governments based on a formula or the cost of collecting the tax; or (iii) piggyback system, where subnational governments are allowed to add a rate onto the central tax and receive the full amount raised from the piggyback.

Most revenue sharing is made on derivation basis. One problem with revenue sharing, especially when different shares are established for different taxes, is that it gives the administering government the incentive to place more effort on collecting those taxes that will give it the most benefits. This has been the case in the People's Republic of China (PRC), India, and Russia. Creating a pool from which shared revenues can be distributed on a formula basis would avoid this complication. However, formula-based revenue sharing is problematic from the viewpoint of macroeconomic management.

Several criteria for tax assignment

In decentralized tax systems, tax policies must be coordinated between jurisdictions to avoid distortion in the free movement of economic resources (labor, capital, goods, and services) from one region to another, and prevent mobile taxable goods and services (such as capital) from migrating to attractive regions with low tax rates. Such migration would cause jurisdictions to compete with one another through lower taxes or other inducements, and thus create an inefficient and opaque fiscal system in the aggregate.

There should also be rules for allocating tax revenues among jurisdictions to avoid double taxation or no taxation at all. As noted, where the tax bases are relatively mobile, decentralized tax assignment opens opportunities for tax avoidance and evasion.

Taxes assigned to central government should

- *cover mobile tax bases* to avoid movements of factors of production and interjurisdictional tax competition;
- *be sensitive to changes in income* to provide the central government with stabilization instruments and to partly shelter the budgets of subnational governments from cyclical fluctuations; and
- *cover tax bases that are unevenly distributed across regions*. Taxes on natural resources are an example. In this case, however, since the exploitation of the environment will affect the local government concerned, the tax base should therefore be shared between the central and the local government.

Correspondingly, local taxes require

- a relatively immobile tax base;
- an adequate tax yield to meet local needs and the buoyancy to grow at least at the same rate as expenditures;
- a stable and predictable tax yield over time;
- relatively easy administration; and
- a nonexportable tax burden on nonresidents

Table 8.1 shows salient characteristics of four main groups of revenue sources to guide the choice of local taxes. The criteria refer to the above characteristics of an ideal local tax: *mobility* refers to the mobility of the tax base; *adequacy*, *buoyancy*, and *stability* refer to the tax revenues; *fairness*

refers to the conventional notion of tax progressivity; and *administration* refers to the ease with which the tax is administered at locally determined rates.

A Menu of Revenue Instruments

The following considerations apply to the major kinds of taxes. Table 8.2 provides the conceptual basis for tax assignment.

Box 8.6
Fiscal Federalism in the United States

The United States provides a good example of how the revenue assignment system can work. The Constitution allows the states to perform all functions that are not expressly reserved to the Federal Government and do not violate the Constitution, and to levy any tax that does not restrict interstate commerce. For their part, most states have a self-imposed balanced-budget constraint, and determine the rights and powers of their constituent local levels of government. Federal grants, mainly for externalities and equalization, account for about 20 percent of state and local government expenditures.

Table 8.1
Local Taxes

Criteria	Property Tax	Income Tax	Sales Tax	Business Tax
Mobility	+	-	-	-
Adequacy	-	+	-	?
Buoyancy	-	+	+	+
Stability	+	-	-	-
Exportability	+/-	+/-	+	-
Visibility	+	+	+	-
Fairness	+	+	?	-
Acceptability	-	-	?	+
Administration	?	+	?	+

+ good

- bad

+/- good to the extent that it falls on residents; bad to the extent that it falls on nonresidents

? indeterminate

Source: Bird (1995).

Table 8.2
Conceptual Bases of Tax Assignment

Type of Tax	Deter- mination of Base	Rate Setting and Collection	Adminis- tration	Comments
Customs Tax	F	F	F	International trade taxes
Corporate Income Tax	F, U	F, U	F, U	
Resource Tax	F	F	F	Very unequally distributed tax bases
Resource Rent (profits/income) Tax				
Royalties, Fees, Charges; Severance Tax;	S, L	S, L	S, L	Benefit taxes/charges for state-local services
Production, Output, and Property Tax				
Conservation Charges	S, L	S, L	S, L	To preserve local environment
Personal Income Tax	F	F, S, L	F	Redistributive, mobile factor, stabilization tool
Wealth Tax (tax on capital, wealth, wealth transfers, inheritance, and bequests)	F	F, S	F	Redistributive
Payroll Tax	F, S	F, S	F, S	Benefit charge, e.g., social security coverage
Multistage Sales Tax (value-added tax [VAT])	F	F	F	Border tax adjustments possible under federal assignment; potential stabilization tool
Single-Stage Sales Tax (manufacturers/wholesale/retail)				
Option A	S	S, L	S, L	Higher compliance cost
Option B	F	S	F	Harmonized, lower compliance cost

continued on next page

Table 8.2 (cont'd.)

Type of Tax	Deter- mination of Base	Rate Setting and Collection	Adminis- tration	Comments
"Sin" Tax				
Excise Tax on Alcohol and Tobacco	F, S	F, S	F, S	Health care a shared responsibility
Betting, Gambling Tax	S, L	S, L	S, L	State and local responsibility
Lottery Tax	S, L	S, L	S, L	State and local responsibility
Racetrack Tax	S, L	S, L	S, L	State and local responsibility
Taxation of "Bads"	F	F	F	To combat global/national pollution
Carbon Tax				
BTU Tax	F, S, L	F, S, L	F, S, L	Pollution impact may be national, regional, or local
Motor Fuel Tax	F, S, L	F, S, L	F, S, L	Tolls on federal/provincial/local roads
Effluent Charge	F, S, L	F, S, L	F, S, L	To deal with interstate, intermunicipal, or local pollution issues
Congestion Toll	F, S, L	F, S, L	F, S, L	Tolls on federal/provincial/local roads
Parking Fee	L	L	L	To control local congestion
Motor Vehicle Tax				
Registration, Transfer Tax, and Annual Fee	S	S	S	State responsibility
Driver's Licenses and Fee	S	S	S	State responsibility
Business Tax	S	S	S	Benefit tax

continued on next page

Table 8.2 (cont'd.)

Type of Tax	Deter- mination of Base	Rate Setting and Collection	Adminis- tration	Comments
Excise Tax	S, L	S, L	S, L	Residence-based tax
Property Tax	S	L	L	Completely immobile factor, benefit tax
Land Tax	S	L	L	Completely immobile factor, benefit tax
Frontage, Betterment Tax	S, L	L	L	Cost recovery
Poll Tax	F, S, L	F, S, L	F, S, L	Payment for local service
User Charges	F, S, L	F, S, L	F, S, L	Payment for services rendered

F = federal; L = municipal or local; S = state or province; U = supranational entity

Source: Shah (1998).

Value-added tax

Local administration of a value-added tax (VAT) is problematic, as each local government could set its own standard tax rates and methods of administration. There are also opportunities for local protectionism by setting higher VAT rates on purchases from outside suppliers. But even if the VAT rate and base structure are determined by central government, VAT proceeds should not be shared between levels of government; otherwise, some resource-rich areas would benefit greatly, while others would collect little net revenue.⁶

Nonetheless, the VAT is a subnational tax in Brazil and some transitional economies (e.g., People's Republic China and Russia) where central and provincial governments share VAT proceeds on a derivation basis. The problems noted above are mitigated because the tax is collected by a central tax service, and (in the People's Republic China, at least) the central government makes up for low yield in exporting to the provinces. Still,

protectionist measures have been taken in some Chinese provinces. In Brazil, the decision to allow VAT as a subnational tax has led to administrative problems and economic distortions. Overall, one useful way to funnel VAT proceeds to subnational governments is for the central government to administer and collect VAT, and earmark a share of it for a distributable pool, to be allocated among the recipient local governments on a formula basis.

Corporate income tax

The corporate income tax must be levied by the central government since it fails all the tests of a good local tax: it imposes high compliance costs, generates incentives for tax avoidance, offers an opportunity to export the tax burden to other regions, and is an uncertain and volatile revenue source. Corporate income taxes are still levied at the subnational government level in many developing and transitional economies and especially in the latter, where this tax base is among the fastest growing. Problems have not yet arisen because businesses tend to operate in a single province, but they will become apparent once businesses begin to operate in more than one province. It would therefore be advisable to begin tax planning in preparation for a smooth shift in company tax administration responsibilities.

Personal income tax

The individual income tax is a popular tax instrument for central government in most countries. The tax is, however, assigned to subnational governments in some countries (the Scandinavian countries, Switzerland, the Baltic countries, Russia, and the other former Soviet Union countries). Assigning personal income tax to subnational governments has advantages and disadvantages.

The personal income tax does meet most of the tests of a good subnational government tax: it is relatively easy to administer, resident-based, buoyant, and has fairly stable yields. However, the personal income tax is related to the redistribution function of a central government and is therefore more appropriately left to the central government. Also, it is the single best instrument of countercyclical fiscal policy.⁷ Finally, because of labor mobility, there is never a perfect correspondence between individuals' residence and the place where they receive their income.⁸

Excise and sales taxes

These are appropriate for subnational government if levied on businesses that operate within local boundaries. Local governments can thus recover the costs of “housing” these industries and public service costs. The tax is, however, not beneficial to local governments if levied against monopolistic industries because there is no correspondence between the tax burdens and expenditure benefits within local boundaries. Retail sales taxes are commonly used by local governments, as the burden falls on the taxing jurisdiction, administration is relatively easy, and revenue yield is significant and grows approximately in proportion to local public expenditure requirements.

Motor vehicle tax

Motor vehicle ownership and use represent an excellent but much neglected tax for urban governments in developing countries. Motor vehicles are easily taxable, and the tax burden falls on persons with higher incomes. All forms of vehicle taxation are likely to improve the distribution of income, and in terms of horizontal equity, most may be considered fair (Box 8.7). Vehicles used for public transport and financing for lower-income people can easily be exempted from such taxes.

Property and land taxes

Residential property taxes are often considered the ideal tax for local governments. Since property owners are the primary beneficiaries of local government services, the tax on *real* property is directly related to their benefits. Also, the tax is better administered by local governments rather than by the central government since it requires identifying each parcel of property and tracking improvements in those properties and changes in ownership. There are problems and limitations, however, when the quality of services is systematically higher in localities with higher property values and hence greater revenue (Box 8.8)

Box 8.7 Tax on Motor Vehicle Ownership

There are different ways of taxing motor vehicle ownership and use. Each of these has advantages and disadvantages for subnational governments.

Restricted area license charges and *parking fees and taxes* are most desirable in terms of economic efficiency: they can be designed to approximate the excess of the social over the private cost of using congested streets without restricting the use of uncongested streets. *Local fuel taxes* and *unrestricted license taxes* can be expected to provide good yield, buoyancy, and stability. *Automotive sales and transfer taxes* are likely to be less effective in revenue performance because of the narrower tax base and the greater likelihood of year-to-year variations in the base. *Fuel taxes* are the easiest to administer and are relatively easy to impose because they are usually hidden in the sales price of the fuel. Road tolls are also likely to be accepted by the public since they are linked to the benefit derived from the use of the roadway. *Local fuel and sales taxes* can overlap substantially with the national taxing authority and require greater coordination with the central government. On the other hand, *license taxes* and *congestion and parking charges* in most cities can normally be imposed without interference from higher-level governments.

Box 8.8 Local Property Taxes

The property tax is undoubtedly the most widespread form of local taxation. Unfortunately, experience suggests that such taxes are not easy to administer, particularly in countries where inflation is endemic (for example, Brazil), and that they are never politically popular owing to their visibility and certain inherent administrative difficulties. Even in the most sophisticated countries, local property taxes can seldom yield enough to finance local services. As noted elsewhere, no developed country that depends significantly upon property taxes for local fiscal resources has a local government sector that accounts for more than 10 percent of total public spending (Bird and Slack 1991). Similarly, property taxes seldom account for more than 20 percent of local current revenues—or less than 1 percent of total public spending—in developing countries. Moreover, despite substantial efforts in some countries and considerable foreign assistance, these figures have not changed (Dillinger 1991). The property tax, it appears, may be a useful, even necessary, source of local revenue, but it is most unlikely to provide sufficient resources to finance a significant expansion of local public services in any country. Indeed, countries have often been hard-pressed even to maintain the present low relative importance of property tax revenues in the face of varying price levels and political difficulties.

continued on next page

Box 8.8 (cont'd.)

A recent study (Dillinger 1991) concludes that a number of conditions must be satisfied for local property taxes to play a more important role in financing local activities. The political costs of relying on the property tax are so high that no government will willingly risk doing so provided it has access to cheaper sources of finance. Intergovernmental transfers, which can be spent as local governments wish (such as access to taxes on business which can largely be exported), must therefore be curtailed not simply to make property taxes more attractive, but more importantly, to confront local decision makers with the true economic and political costs of their decisions.

But even if this structural precondition is met, a number of other policy reforms are needed to turn the property tax into a responsive instrument of local fiscal policy. First, local governments must be allowed to set their own tax rates: very few developing countries give their local governments freedom in this respect. Second, the tax base must be maintained adequately. In countries with inflation, some form of index adjustment is therefore advisable. In other countries, the assessing agency must be provided with direct financial incentives to keep the tax base up to date. Finally, a series of procedural reforms is often needed to improve collection efficiency, valuation accuracy, and the coverage of the potential tax base (Kelly 1994). None of these steps are easy, either politically or, in some instances, in terms of available technical resources. Nonetheless, countries that want to have responsive as well as responsible local governments must follow this hard road. There are no shortcuts to successful local property taxation.

Source: Bird (1995).

Nontax revenues

Local governments may depend more on user and benefit charges, which can be efficient and relatively easy to administer, and can provide significant revenues. In the US, about one sixth of state and local government revenues comes from these sources. In most countries, however, revenues from user and benefit charges remain a distant potential rather than a reality. Often, revenue-generating essential local services are provided at subsidized rates. In the People's Republic of China and Russia, for example, public transit, utilities, and housing are not self-sustaining and, in fact, are part of national wage policy. The same holds true in many developing countries where the poor population is large, and affordability and politics are major problems.

Lottery proceeds are also sometimes a popular way of raising local revenue. Lotteries are easy to administer, and the tax is well hidden from public perception and generally produces no public resistance or resentment. However, lotteries are the most regressive form of taxation, falling almost exclusively on the poor, and should not be considered as an efficient and equitable source of local government revenue, especially in developing countries.

HORIZONTAL IMBALANCE: INTERGOVERNMENTAL FISCAL TRANSFERS

Intergovernmental fiscal transfers are instruments to correct the horizontal or vertical imbalances in the fiscal capacities of different subnational governments. These fiscal transfers can be broadly grouped into revenue-sharing arrangements and grants. Revenue sharing was discussed earlier. Grants can be conditional or unconditional, and open-ended or subject to ceilings. The mix of these transfers depends on the objectives of policymakers.

Policy Options and Conflict

The policy options for countering vertical and horizontal imbalances are

- correct each imbalance separately;
- correct both imbalances in an integrated system of equalization grants;
or
- correct only the vertical imbalance and largely ignore the horizontal imbalance.

In the first policy option, the vertical imbalance can be addressed through tax-sharing or grant arrangements, and the horizontal imbalance through transfer payments from rich to poor regions. This is the approach used in Germany. In the second option, used in Australia and Canada, horizontal and vertical imbalances are addressed simultaneously through a system of grants that includes both equalization payments and special-purpose grants. The last option makes use only of tax-sharing and grant arrangements. However, it can also be matched with special-purpose grants, as is broadly the case in the US, to reduce horizontal imbalance in specific functional areas (Box 8.9).

Box 8.9
Fiscal Transfers: Principles and Practices

Objective	Grant Design	Good Practices	Practices to Avoid
To bridge fiscal gap	<ul style="list-style-type: none"> • Reassigning responsibilities • Tax abatement • Tax sharing 	Tax abatement in Canada and tax base sharing in Brazil, Canada, and Pakistan	<ul style="list-style-type: none"> • Deficit grants • Tax-by-tax sharing as in India
To reduce regional disparities	<ul style="list-style-type: none"> • General nonmatching • Fiscal capacity equalization transfers 	Fiscal equalization programs of Australia, Canada, and Germany	General revenue sharing with multiple factors
To compensate for benefit spillovers	<ul style="list-style-type: none"> • Open-ended matching transfers with matching rate consistent with spillout of benefits 	RSA grant for teaching hospitals	
To set national minimum standards	<ul style="list-style-type: none"> • Conditional nonmatching block transfers with standards of service and access conditions 	<ul style="list-style-type: none"> • Indonesia roads and primary education grants • Chile, Colombia, and South Africa education transfers 	<ul style="list-style-type: none"> • Conditional transfers with conditions on spending alone • Ad hoc grants
To influence local priorities in areas of high national but low local priority	<ul style="list-style-type: none"> • Open-ended matching transfers (preferably with matching rate to vary inversely with fiscal capacity) 	Matching transfers for social assistance as in Canada	<ul style="list-style-type: none"> • Ad hoc grants
To stabilize the economy	<ul style="list-style-type: none"> • Capital grants, provided maintenance is possible 	Limited use of capital grants and encouraging private-sector participation by providing guarantees against political and policy risks	<ul style="list-style-type: none"> • Stabilization grants with no future upkeep requirements

Source: Shah (1998).

Policy objectives in addressing vertical and horizontal imbalances may either agree or conflict with each other. They may include the following:

- ensuring overall fiscal stability for the national economy;
- providing an acceptable degree of equity between individuals in different regions;
- encouraging efficient use of resources across the country; and
- ensuring minimum standards for services provided.

To illustrate these conflicts, when the central government increases income taxes for financial stabilization, it will inevitably reduce the tax bases of local governments and, hence, local revenue. Conversely, reducing central expenditures may raise expenditure needs at the local level. The central government, hoping to raise education standards in a certain region, for example, may opt to provide the local government with larger education grants even if the subnational government has greater revenue than other subnational governments but has invested poorly in education in the past.

Fiscal Transfer Options

The main transfer options may be grouped into two major categories: (i) conditional or specific-purpose transfers and (ii) unconditional transfers. In turn, conditional transfers may be matching grants, requiring a corresponding local contribution; or nonmatching grants for specific purposes. Unconditional grants may take the form of either revenue-sharing arrangements or block grants, general-purpose grants that are in effect budget support for local government. Close-ended distribution refers to grants with caps; open-ended distribution to grants without ceilings. The matrix in Table 8.3 summarizes these options.

Transfers may be given only to poor regions by central governments, or may be organized on a cooperative basis from richer to poorer regions. Both types of distribution can be transparent. Germany uses the latter type of distribution. Other countries will be able to replicate the German system only to the extent that they enjoy the same high degree of political cohesion. Elsewhere, the very visibility of the redistribution criteria may lead to strong political opposition by better-off provinces, particularly when regional ethnic differences are significant. In these cases, equalization transfers from the center to all provinces are preferable and may be politically inevitable.

Table 8.3
Fiscal Transfer Mechanisms

Transfer Mechanism	Mode	Redistribution Criterion
Conditional Transfers	Matching grants	With or without equalization formula, Close- or open-ended
	Nonmatching grants or specific-purpose payments	
	Block grants	
Unconditional Transfers	Revenue-sharing arrangements	With or without equalization formula
	General-purpose grants	Open- or close-ended

Central governments use *conditional grants* to increase influence over local spending, to attain and maintain minimum standards of local services, or to ensure a socially optimal outcome, especially in cases of interjurisdictional spillovers. The extent to which central governments impose conditions on grants varies from one country to another. At one extreme, conditions may be such that subnational governments are reduced to acting as mere agents of the central government; at the other extreme, conditions may be limited to reporting, leaving subnational governments with wide elbow room for local innovation and experimentation.

Matching grants are particularly effective in addressing spillover problems. Matching grants generally alter local spending priorities, as local governments adjust their finances to take the central governments' expenditure preferences into account. Indeed, changing local priorities is an objective of matching grants. These grants however also improve the leverage of local governments with respect to the size of the grant because of the size of their own contribution.

Capital grants specifically finance public investment projects or the delivery of vital public services for subnational governments. They are normally used in countries where the capital markets are not well developed, or where subnational governments do not have the fiscal strength to access such markets directly.

As mentioned earlier, capital needs are normally excluded from consideration in formulating equalization grants because of the difficulties associated with measuring and assessing the relative investment needs of different regions. A prudent approach may consist of using *block grants* or a *general-purpose equalization grant* to finance large infrastructure projects (such as regional airports and irrigation projects), and some recurring investments (such as roads and housing) financed through capital grants, with smaller investments. (See Schiavo-Campo and Tommasi [1999] for an analysis of the process of public investment programming.)

Open-ended grants encourage local governments to internalize identified spillovers and to deliver the required level of services. Of course, such arrangements are dangerous for overall macroeconomic stability, and central governments generally prefer capped grants with absolute monetary ceilings.

Grants may have a built-in redistribution mechanism or simply be distributed on an equal per capita basis. Redistribution mechanisms are usually used for general-purpose transfer systems, but can also be part of conditional grants, as in cases where poorer regions with greater education or health needs receive more grants. However, this approach then requires an overall framework for evaluating whether grants formulated separately can actually achieve the aggregate equalization objective.

One risk with all types of transfers from the central to local government is inducing local government to overspend without a clear link to citizens' preferences—the so-called “flypaper effect”, which describes a situation where the direct link between the taxpayer or voter and the services provided is broken. This is based on an empirical investigation of a number of countries, where revenues shared with local governments tend to “stick” with the latter in the form of higher expenditure rather than being passed on to taxpayers in the form of lower taxes. Hence, overprovision of services is not an explicit manifestation of public choices for those services but only of the greater availability of funds from central government. Empirical estimates suggest that the magnitude of the flypaper effect in some countries is considerable (Ahmad and Craig 1997). Of course, the solution to this problem lies in the hands of the local population and depends on the strength of the accountability mechanisms at local level.

Fiscal Capacity Equalization Transfers

More important than just filling fiscal gaps, fiscal transfer mechanisms should redistribute resources so that all regions will have the same financial capacity to provide the same standard of basic public services, assuming that they exert the same effort to raise incomes from their own sources and operate at an average level of efficiency. In an effort to equalize horizontal differences among subnational jurisdictions, the national government may try to resolve through unconditional equalization systems only regional differences in revenue or tax assignment, as in the case of Canada.

A more complicated formula is needed if both expenditure and revenue differences are simultaneously addressed, as in the case of Australia and Denmark, where the formulation of transfers incorporates the assessment of revenue capacities as well as expenditure needs (Box 8.10). The People's Republic of China introduced an interesting pilot scheme in that direction (Box 8.11).

In formulating such transfers, it is especially important to estimate expenditure needs independently of the actual expenditure of individual subnational governments. Otherwise, the transfers will be merely gap filling, with the obvious risk that recipient local governments will raise their expenditure to receive larger transfers. But such a system should also distribute lump-sum transfers so that even if equalization factors are taken into account, the recipient subnational governments can choose how to spend the money.

Box 8.10

Fostering Interregional Equity through Fiscal Equalization in Australia

Although Australia is a federal country comprising eight states and territories, most taxation power is assigned to the federal (Commonwealth) government, which accounts for almost three fourths of general government revenue. The federal nature of the system is preserved through large-scale intergovernmental fiscal transfers: in 1998–1999, these totaled about US\$20 billion equivalent, about half of which came in the form of unconditional block grants.

The fiscal transfer mechanism is designed to address both vertical and horizontal fiscal imbalances (see text). The vertical imbalance is addressed by transferring enough resources to permit states and local governments to spend almost 50 percent of general government expenditure (while raising about one fourth of revenue). The Australian system also has a mechanism to partly remedy the horizontal fiscal imbalance—differences in revenue capacity among the states—by focusing on equal access for all citizens to certain basic social services.

Until World War II, the annual negotiation between the states and the federal government concerned both the total amount of grants to be allocated and their distribution among the states. This generated a great deal of contention and the zero-sum nature of the allocation system made a national consensus very difficult. In the system introduced since then, the annual negotiation has centered only on the total amount. As soon as that figure is agreed, the allocation among the states follows a formula designed to equalize access to basic social services (thus providing a greater per capita amount to poorer states).

According to the allocation principle, each state is given “the capacity to provide the average standard of state-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.” This simple and powerful principle sets all the incentives in the right direction. Because these averages are *assumptions* used in the allocation formula, each state has a positive incentive to raise its revenue effort and its service efficiency above the national average. If it succeeds, it retains the increase in revenue and all the cost savings, and the national averages for the following years are automatically raised, adding a dynamic dimension to the fiscal and efficiency incentives.

In 1997, one of the authors asked the Chairman of the Australian Grants Commission whether the efficiency of the system depended on the relative interregional equality of income evident in Australia. He replied, rightly, “And how do you think it got that way?” Assuring that each citizen has access to quality basic education and health is probably the best single route to remedying both interpersonal and interregional income inequalities in the long term.

Source: Frank Jotzo (to be published); author’s interview with the Grants Commission chairman, January 1997.

Box 8.11
Pilot Equalization Scheme in the People's Republic of China

As a first step toward a formula-driven redistributive system, the People's Republic of China (PRC) introduced in 1995 a pilot transfer payments scheme. It was aimed at solving the urgent problem of meeting payroll in some provinces. Initially, the formula had two parts: an objective factor that attempted to measure the gap between standard expenditures and local fiscal capacity, and a factor for subsidies to regions with large ethnic minority populations. The latter was in line with the PRC policy for improving the welfare of its minorities.

The fiscal shortfall was determined by standard expenses on wages of civil servants, standard administrative expenses, agriculture and other productive expenditures, and other expenditures such as price subsidies. On the other hand, special transfers to provinces with minority regions were determined by the fiscal gap between the minority regions and the national average.

In 1996, another factor was added to the formula to reward the provinces for good tax effort. Tax effort is now measured by provincial tax collection relative to the national average. Generally, the transfers that a province was expected to receive in 1999 would be based on its fiscal gap and tax efforts in 1998.

There is large room for improving the PRC fiscal transfers system. For one, stronger links still need to be established between a province's fiscal need and its transfers. Also, there should be a better means of measuring provincial revenue growth, since it depends on a number of factors other than tax effort. Finally, over the long term, there is a need to measure fiscal needs more appropriately to include factors other than government personnel and costs of government.

For a detailed elaboration of the pilot transfer payments scheme in the PRC, refer to Annex IV of this chapter.

As repeatedly stressed in this book, one should be very skeptical of imported "models" of public administration. However, the Australian fiscal equalization system described in Box 8.11 comes close to the notion of a good "model" to be considered by other countries because it provides positive incentives to the constituent states for fiscal mobilization and for efficiency in basic social services. Moreover, it takes the politics largely out of the contentious issue of geographic allocation of resources. It does so through a mechanism of grants to the states, calculated *as if* each state had average efficiency in local resource mobilization effort and in service provision. States with greater than average efficiency retain all of their higher-than-average revenue or cost savings. This system is

worth considering even in developing countries, particularly those where different ethnic groups are concentrated in different regions. However, because the effectiveness of the system depends largely on solid data about local revenue and unit cost of services, countries must first ensure that such data are available and have wide credibility. Annex III elaborates on an equalization grant system.

Designing Intergovernmental Fiscal Transfers

The following provides pointers (Shah 1994) on designing fiscal transfers. Some criteria may conflict with others. Policymakers must therefore assign priorities to the various factors.

- *Autonomy*—Subnational governments should have complete independence and flexibility in setting priorities and should not be constrained by the categorical structure of programs or uncertainty associated with decision making at the center. Consistent with this objective is tax-base sharing (which allows subnational governments to introduce their own tax rates on central bases), formula-based revenue sharing, or block grants.
- *Revenue adequacy*—Subnational governments should have adequate revenues to discharge their designated responsibilities.
- *Equity*—Allocated funds should vary directly with fiscal need and inversely with the taxable capacity of each province.
- *Predictability*—The grant mechanism should ensure predictability of the subnational government's shares by publishing five-year projections of funding availability.
- *Efficiency*—The grant design should be neutral with respect to subnational government choices or resource allocation among different sectors or different types of activity. The current system of transfers to finance lower-level public sector wages in countries such as Indonesia and Sri Lanka contravenes this criterion.
- *Simplicity*—The subnational government's allocation should be based on objective factors over which individual units have little control. The formula should be easy to comprehend so that "grantsmanship" is not rewarded, as has apparently occurred with plan assistance in India and Pakistan.
- *Incentive*—The proposed design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance the deficits of subnational governments.

- *Safeguards for the grantor's objectives*—The grant design should ensure that the grant recipients adhere to certain well-defined objectives of the grantor. This is accomplished through proper monitoring, joint progress reviews, and technical assistance with the help of a selective matching transfer program.

SUBNATIONAL GOVERNMENT BORROWING

Local borrowing has become an important issue in intergovernmental fiscal relations. Aside from the growing share of local debt and deficits over time, local borrowing has spurred macro concerns because of the debt crisis in some subnational governments in Brazil, the inflationary impact of subnational financing in Argentina, and city-level bankruptcies in the US.

Types of Local Financing

Borrowing is a major source of funds for the capital requirements of subnational governments, especially if large capital investment responsibilities are decentralized. Increases in current tax revenues will normally not suffice to finance public investments that are lumpy in nature. Also, since the benefits of public investments presumably last for decades, public borrowing allows future beneficiaries to share in financing such investments. Borrowing may also serve as a useful stopgap for local deficits caused by a vertical imbalance in subnational government revenue and expenditure assignments.

Subnational governments may obtain financing in four ways: (i) borrowing through the central government, (ii) borrowing through another public intermediary, (iii) borrowing directly from the capital markets, or (iv) financing through private participation in the delivery of public services. This last element is discussed in Chapter 6.

Borrowing through the central government ensures subnational governments of long-term credit. A major disadvantage, however, is that credit allocation through this channel will most likely become enmeshed with politics, possibly resulting in inefficient borrowing for unproductive public investments, as politically attractive investments are not necessarily the productive ones. To a lesser extent, the same is true for borrowing through a public financial intermediary, with the additional disadvantage that the debt of a financial intermediary is an implicit liability of the central government and thus less transparent.

In contrast, subnational governments' direct access to capital markets allows for the development of a more transparent and market-based relationship with lenders, and a greater chance for the central government to enforce a hard budget constraint. This is easier said than done in developing countries and transitional economies, where capital markets are nonexistent or are highly imperfect. It may still be possible, however, to explore possibilities for some local governments to access the international capital markets. Evidentiary requirements will be heavy and interest rates higher, of course (unless a central government guarantee is provided—which would be entirely inconsistent with the principles discussed here), but a good track record of timely repayment will lessen these problems in time for the local government concerned.

The main issue here is moral hazard. Subnational government access to capital markets involves implicit central-government guarantees, which allows imprudent action by both lenders and subnational governments, creating contingent fiscal liabilities for the central government. (On the general issue of fiscal risk, see Schiavo-Campo and Tommasi [1999], and for an in-depth analysis, Polackova [1998, 1999].) Accordingly, imprudent behavior carries no penalty, and good local fiscal discipline earns no reward. The key to appropriate policies on subnational borrowing is the proper design of fiscal decentralization in general, and the design of the mechanism for controlling local borrowing powers, in particular.

Three important considerations must be taken into account in designing decentralized borrowing powers: (i) minimize, if not eliminate, the implicit central government liability; (ii) insulate credit allocation from political influence; and (iii) strengthen capital markets as the preferred channel for local government credit.

Control of Subnational Borrowing

A good system of decentralized borrowing is one in which the regulatory framework controls excess borrowing through the following.

- Subnational governments should be required to disclose adequate and timely financial information based on standard accounting to both potential lenders and the central authorities.
- Explicit bankruptcy procedures should ensure that delivery of basic services continues, even at a reduced level, during the debt management and restructuring period.

- Local borrowing in excess of specified amounts or for violation of specified criteria should be subject to penalties.
- Subnational governments must be assured of access to revenue sources to serve as collateral for their debts. Without such collateral, lenders will rightly assume an implicit guarantee from the central government.

Various countries use different mechanisms to control subnational borrowing. These mechanisms may be broadly grouped into four categories: (i) control through market discipline, (ii) cooperation among different levels of government, (iii) controls based on administrative rules, and (iv) direct controls by the central government. Most countries use a combination of these approaches. Box 8.12 presents a comparative summary of control mechanisms in various countries.

The market discipline approach

Relying on the capital markets to control local borrowing assumes that a capital market exists and functions reasonably well; the government lets the capital market operate freely, without favoring government borrowers; and a bailout in case of default is perceived to be unlikely. As noted earlier, the realities in developing countries suggest that these countries cannot rely on market discipline. Most developing countries have widespread experience with central government intervention to prevent default by subnational governments. Also, because of short-term electoral cycles, local politicians tend to be unresponsive to warnings from the credit market.

The cooperative approach

Local borrowing can also be controlled through negotiation between the central and subnational governments. As argued at the start of this chapter, fiscal deficit targets should be set to cover the general government, prevent downloading of the central deficit, and improve overall fiscal transparency. For this to be realizable, however, subnational governments should be allowed to participate in some appropriate fashion in formulating macroeconomic programs and of the fiscal framework. This approach may slow the process somewhat, but has the greater advantage of promoting the flow of information among levels of government, thereby increasing awareness among subnational government officials of the fiscal implications of their actions and improving the overall effectiveness of the public expenditure management system. The cooperative approach can work best

Box 8. 12
Subnational Borrowing Controls in Selected Countries^a

Country	Market Discipline		Cooperative Control		Administrative Control		Rule-Based Control		Borrowing Prohibited	
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Industrial Countries										
Australia			■	■						
Austria					■					
Belgium			■	■						
Canada	■									
Denmark		■	■	■						
France	■									
Germany							■			
Greece					■					
Ireland					■					
Italy							■			
Japan										■
Netherlands							■			
Norway										
Portugal	■				■					
Spain							■			
Sweden	■									
Switzerland									■	
United Kingdom					■				■	
United States									■	

^a Classifications indicate the predominant form of control. Some countries may use a combination of several techniques.

Box 8. 12
Subnational Borrowing Controls in Selected Countries^a

Country	Market Discipline		Cooperative Control		Administrative Control		Rule-Based Control		Borrowing Prohibited	
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Developing Countries										
Argentina					■		■			
Brazil					■		■			
Bolivia					■		■			
Chile					■		■			
Colombia					■		■			
Ethiopia							■			■
India							■			
Indonesia					■		■			
Korea, Republic of					■		■			
Mexico					■		■			■
Peru							■			
South Africa			■							
Thailand									■	
Transitional Economies										
Albania									■	
Armenia									■	■
Azerbaijan									■	■

^a Classifications indicate the predominant form of control. Some countries may use a combination of several techniques.

Box 8. 12
Subnational Borrowing Controls in Selected Countries^a

Country	Market Discipline		Cooperative Control		Administrative Control		Rule-Based Control		Borrowing Prohibited	
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Belarus									■	■
Bulgaria									■	■
China, People's Republic of									■	■
Estonia					■					
Georgia						■				■
Hungary					■					
Kazakhstan									■	■
Kyrgyz Republic									■	■
Latvia					■					
Lithuania						■				
Poland									■	■
Romania									■	■
Russia	■									
Slovenia									■	■
Tajikistan									■	■
Ukraine									■	■

^a Classifications indicate the predominant form of control. Some countries may use a combination of several techniques.

Source: Ter-Minassian, ed. (1997).

in a situation where local officials are reasonably competent and representative, and where there is strong national leadership in economic and fiscal management. (Box 8.13.)

Box 8.13

Cooperative Approach to Controlling Local Borrowing in Australia

Australia uses the cooperative approach through its Loan Council, a long-established forum for the negotiation of state debts. Comprising representatives from all the Australian states and one from the central government, the council discusses the global debt limits of each state and monitors compliance with such limits. Monitoring is done through a before-and-after analysis of outstanding debts.

State borrowing was characterized by attempts to elude debt limits by resorting to off-budget operations, innovative financing techniques, and through borrowing by state-owned enterprises. Therefore, the Loan Council, in 1993, decided to shift its focus to prior analysis and subsequent monitoring of the net financing requirements of each state. It requires the states to present detailed projections of their yearly budgetary operations to show developments in their finances. To strengthen market discipline on state borrowing, the council facilitates the collection and timely dissemination of this information.

Source: Ter-Minassian and Craig in Ter-Minassian, ed. (1997).

Rule-based approach

This approach makes use of the constitution and laws to restrict and guide subnational government borrowing. Among other things, rules for borrowing commonly set absolute limits for subnational government indebtedness; specify the purpose or conditions for borrowing; and prohibit certain types of borrowing that involve macroeconomic risks, such as borrowing from the central bank.

The rules may be determined more by political considerations than by sound macroeconomic management. Also, the approach lacks flexibility and thus fosters practices circumventing the rules, including reclassifying current expenditures as investment; creating off-budget entities whose debts are not included in debt ceilings; borrowing through local government-owned enterprises; using hidden debt instruments (e.g., sale and leaseback arrangements of the so-called “private revenue” bonds in the US); and accumulating payment arrears to suppliers.

Direct control

Particularly in unitary countries, the central government may directly control subnational borrowing in different ways: setting limits on subnational debts; authorizing individual borrowing operations; or centralizing all government borrowing, with onlending to subnational governments. Administrative controls must be more stringent for foreign than for domestic borrowing, for several reasons. The Asian financial crisis has demonstrated however that only fully centralized control of foreign borrowing can prevent the contagion effect of a deterioration of the credit ratings of one borrower on the ratings of other borrowers, and on the country as a whole. The Republic of Korea provides a good illustration of this (Box 8.14).

In developing countries and transitional economies, therefore, direct central control of subnational borrowing appears preferable. But it is very important to avoid cumbersome and intrusive controls. The national authority must not micromanage local government through the back door of controlling its borrowing. There is no substitute for restraint and common sense in the practical implementation of this approach.

Box 8.14**Key Features of the Local Borrowing System in the Republic of Korea**

Local autonomous bodies in the Republic of Korea are allowed to borrow, subject to an elaborate regulatory framework that details the conditions for all debt instruments. The regulatory framework has the following general objectives: (i) to limit the aggregate amount of local borrowing; (ii) to expand the responsibilities of local bodies, given the short period of service of local officials compared with the maturity of debts; and (iii) to spread economic activities to poorer regions of the country.

The regulations for local borrowing in the Republic of Korea include detailed eligibility criteria. Local governments with a history of sound financial policies, such as those with no overdue obligations, a low debt-service ratio, and low fiscal deficit, may borrow. There are also regulations determining the types of projects that can be financed by borrowing. They include capital projects, disaster rehabilitation projects, and welfare improvement projects (not clearly defined). However, there is no preordained central government ceiling on the overall amount of borrowing.

A particular feature of borrowing regulations in the Republic of Korea is compulsory bond placement, a practice introduced in 1979. Cities, through an

continued on next page

Box 8.14 (cont'd.)

ordinance, can decide that those who will benefit from projects financed through borrowing should share in their financing. Aside from compulsory bond placements, local governments can issue bonds on the international market, particularly in Japan and the United States. Bonds are offered at well below domestic market rates, even after considering movements in exchange rate.

The functions and responsibilities of the Government of the Republic of Korea at different levels may be said to be historically closely integrated. This close integration extends as well to the borrowing process. Hence, the risks of borrowing are also shared in the sense that central government approval of any local borrowing automatically implies a state guarantee.

Despite the detailed and strict regulatory framework for borrowing, however, local borrowing could still have adverse macroeconomic effects. The absence of an overall ceiling on borrowing could lead to excessive or poorly timed borrowing, or to the inefficient use of borrowed resources.

Source: Chu and Noregaard in Ter-Minassian, ed. (1997).

KEY POINTS AND DIRECTIONS FOR IMPROVEMENT

Key Points

The *distribution of fiscal responsibilities* between central and subnational governments should be governed by the principles of

- clear responsibilities for each level of government;
- stable and predictable revenue-sharing arrangements;
- providing incentives for increased efficiency of local government; and
- uniform accounting and budgetary rules for subnational government entities.

It is also important for expenditure control and good resource allocation to define fiscal targets to cover general government as a whole, thus avoiding the temptation to dump fiscal problems on local governments; put in place mechanisms to control local government borrowing, and sanction expenditure overruns as well as accumulation of arrears; and assure sound accounting, reporting, and audit.

The potential benefits of *fiscal decentralization* include higher service efficiency—as local government is closer to the users; more effective tax administration; and improved resource allocation and equity. The potential costs are a mirror image of the potential benefits. Fiscal decentralization can worsen service efficiency when local authorities are unresponsive; reduce resource mobilization when local authorities are less honest or capacity is weaker; and foster inequities when local government is “captured” by powerful local interests. The cost-benefit balance of fiscal decentralization depends therefore on the specific country and local situation. Generally, as mentioned earlier, the key influence is the relative quality of governance at central and local levels of government. When local government is more representative and accountable than national government, fiscal decentralization can be presumed to carry a net benefit. Local capacity however needs to be expanded commensurate with the new responsibilities.

How to deal with *fiscal imbalances* is the key implementation issue in fiscal decentralization. Vertical imbalances between central and subnational governments result in general from a mismatch between revenue and expenditure assignments. Horizontal imbalances between subnational government entities at the same level result from differences in wealth and tax revenue between different regions and localities in the country.

Concerning *vertical imbalances*, expenditure responsibilities should in principle be assigned to that geographic level of government where they would benefit only the residents of the region. In practice, however, many public services have unclear benefit regions or carry implications for the country as a whole. Generally, the central government should be responsible for national functions (e.g., defense and international relations), services that benefit several jurisdictions, and services whose local administrative costs would outweigh the local benefits.

Tax assignment to local governments must be accompanied by coordination across jurisdictions—to avoid distortion and undesirable competition in offering tax incentives—and by rules preventing double taxation or tax loopholes. Accordingly, taxes assigned to central government should cover mobile tax bases and tax bases that are unevenly distributed across regions; taxes assigned to local government should be those that cover immobile tax bases as well as tax bases that are easily administered. Therefore, local value-added taxes are generally to be avoided as they carry the risk of competitive tax reduction or, conversely, of local protectionism by setting tax rates higher for purchases from outside suppliers. The corporate income

tax, too, fails the tests of a good local tax, with its high compliance costs, incentives for tax avoidance, and uncertainty of revenue. Assigning personal income taxation to local government has advantages as well as disadvantages. Sales taxes are well suited for local government if they are levied on local businesses. The revenue sources best suited for local administration are local property taxes and motor vehicle taxes, as well as user charges.

As a general rule, *revenue sharing* to remedy overall vertical imbalances should be from the top down, because assigning most taxing power to local government and then sharing revenue upward would weaken the key macroeconomic and redistributive functions of central government. On the other hand, relying entirely on downward transfers would reduce local financial accountability and disempower local government. Local government revenues should therefore comprise an appropriate mix of own-tax revenues as well as some revenue sharing from the top. Revenue sharing can be on a derivation basis, whereby revenue is shared on the basis of where it was collected; on a grant basis, whereby the revenue is redistributed according to a formula or to the cost of collecting the tax; or on a piggyback basis, which allows subnational governments to add a percentage amount to the central tax.

Horizontal imbalances are corrected by intergovernmental fiscal transfers, which can be conditional or unconditional, and open ended or subject to caps. A variety of considerations apply to the different types of transfers. More important than just filling fiscal gaps, however, is the role of fiscal transfers in redistributing resources to assure that all regions have the same financial capacity to provide *basic* public services, assuming they exert the same effort to raise income from their own sources and operate at an average level of efficiency. (The Australian system of grants from the center to the states is particularly effective in this regard.)

As noted earlier, good fiscal federalism requires robust controls on expenditure overruns, arrears, and borrowing by subnational government. When local borrowing carries an implicit national government guarantee, it creates a contingent liability for the national government while encouraging imprudent behavior by both local government and the lenders. In principle, therefore, central government guarantees for local borrowing should be minimized, at the same time as local credit allocation is insulated from political influence from the center, while private capital markets are strengthened as the preferred channel for credit to local governments. This

is particularly difficult to accomplish in developing countries and transitional economies, where capital markets are undeveloped and direct central control of subnational government borrowing remains generally necessary.

Directions of Improvement

The first priority in this area is to review the distribution of fiscal responsibilities between levels of government to make sure that it is clear and explicit. Next, it is necessary to verify that the formal assignment of responsibilities is in fact carried out and, where it is not, to assess whether the lack of implementation derives from insufficient local capacity or from central government interference.

It is also important to combat the temptation to “download” fiscal problems by devolving expenditure responsibilities to local governments without the means to carry them out. This practice makes it difficult for local governments to operate, and at the same time gives them an alibi for bad performance. Defining fiscal targets for general government instead of only for the central government (as recommended in the International Monetary Fund Code of Fiscal Transparency) would help accomplish this purpose. In developing countries and transitional economies, therefore, improving fiscal statistics at the local government level is important not only to promote a healthy fiscal policy overall, but also to help protect local governments against unfunded mandates.

Because fiscal decentralization carries costs and risks as well as benefits, it is essential to examine, *case by case*, whether a specific move toward fiscal devolution is likely to carry a net benefit. Such an examination should rest in part on the feedback of informed persons from local government and civil society, rather than a mere desk review by a central entity. Local administrative capacity is an important determinant of the effectiveness of decentralization. Weak local capacity is not necessarily a reason to keep expenditure responsibilities centralized. However, every move toward fiscal decentralization should be accompanied by measures to strengthen local capacity and governance, and should assure that independent channels of feedback and complaint between the local population and the central government are open.

It is especially important to consider the impact of fiscal decentralization measures on poverty, income distribution, and regional inequalities. Although all major policy changes entail shifts in the

interpersonal and interregional allocation of resources, when a loss is likely for poor and vulnerable groups, appropriate compensatory measures must be incorporated in the design of decentralization and forcefully implemented. Again, there is no substitute for ascertaining the views of local civil society in this respect.

When assigning taxes to local governments, it is necessary to encourage coordination across jurisdictions to avoid undesirable competition in offering tax incentives, double taxation, or tax loopholes. Such coordination can also exploit scale economies in tax administration and improve local administrative capacity by benefiting from the experience of other jurisdictions. Coordination in the tax area can thus become a testing ground for greater general cooperation and, to that extent, can alleviate local capacity constraints and build regional social capital.

Property taxes are the most suitable for assignment to local government, especially in developing countries where the only alternative may be overreliance on transfers from central government. Taxes on certain types of property, such as automobiles, are inherently progressive and relatively easy to administer. However, taxes on land and buildings, which can yield much greater revenue, are difficult to administer and are a frequent source of corruption. Improvements in this area are therefore important for effective fiscal decentralization in developing countries, but always difficult—especially in regions with weak governance and powerful local elites. Directions of improvement include mainly

- giving local governments the freedom to set their own property tax rate;
- improving the property tax valuation system;
- giving the assessing agency direct financial incentives to maintain the tax base and keep assessments up to date;
- strengthening procedures for collecting real estate taxes, normally including the power to seize the concerned property for nonpayment of taxes;
- assuring effective external audit of tax valuations and the assessment process; and
- introducing robust measures to raise the cost of corruption.

The objectives of fiscal transfers are often in conflict—between stabilizing and reducing of regional disparities, or between compensating for benefit spillovers and setting national service standards. Hence, it is important

to ensure that the fiscal transfer system as a whole is internally consistent and trade-offs between objectives are explicit. In practice, this entails relying not on a single type of grant but on a judicious combination of conditional and unconditional, capped and open-ended, and capital and current grants.

In revenue sharing, it is advisable to move away from annual bargaining (which is time-consuming, heavily politicized, and a potential source of corruption) and toward a rule-based arrangement, whereby only the overall amount to be transferred is decided annually, with the distribution to regions and localities governed by explicit criteria. In addition, the tax assignment and revenue-sharing rules must provide the right incentives for efficiency and fiscal discipline by local governments. For example, certain tax-sharing arrangements can lead local governments to put all efforts into collecting those taxes that give them the most benefit, and neglect the rest. A review of the actual behavior of local government in response to central rules, based partly on a survey of informed local opinion, can help pinpoint those rules that have had a disincentive effect, and can be a good basis for improving the fiscal regulatory framework.

Rule-based mechanisms, e.g., centrally set limits on local debt, borrowing, expenditure arrears, and approval of major loans, are also used to assure fiscal discipline in local government. In developing countries, where capital markets are undeveloped and there is an implicit assumption that the central government will bail out local governments if they get into trouble, such direct controls are unavoidable. It is important, however, to exercise them efficiently, avoiding cumbersome and intrusive controls that micromanage local government under the guise of controlling its borrowing.

Annex III

EQUALITY IN DIVERSITY: FISCAL EQUALIZATION IN AUSTRALIA

by Frank Jotzo

INTRODUCTION

The Australian fiscal equalization system is often seen as a model for other countries because of several reasons. Fiscal equalization manages to overcome large imbalances between own sources of revenues and own expenditures at the regional level. In doing so, the transfer system aims to distribute the funds so that all states have equal capacity to fulfill their fiscal responsibilities. Further, the grant system is designed to allow the states to decide how they use the funds and to avoid central government interference in state policy choices. This article examines the fiscal relations between the federal and state governments in Australia, looking in particular into the design of the grant system. It should be stressed here, that for incentive reasons, it is preferable to assign sufficient own sources of revenues to regional governments. However, a well-designed grants system can be a reasonable second-best solution for overcoming fiscal imbalances.

FISCAL IMBALANCES IN AUSTRALIA

Revenues

Australia is a federation of eight states and territories. There are three layers of government, namely, the federal, state, and local governments. The Australian tax system has evolved in a way that has given the central level ever more taxation powers. Today, all major taxes are levied by the federal government. Of these, the income tax is the most important. In a tax reform effective from July 2000, a value-added tax will be introduced. The states levy a variety of smaller and often inefficient taxes, such as payroll tax (on wage payments by employers), transactions taxes (stamp duties and taxes on financial transactions), as well as taxes on tobacco, alcohol, petrol and gas, motor vehicles, and gambling. These taxes are regulated by the states and vary between states (Australia 1998a). After introducing the value-added tax, some of these taxes will be abolished.

The federal government (Commonwealth) levies 76 percent of the total tax revenue, and accounts for 72 percent of total government revenue in Australia. The States account for only 24 percent and local government for 4 percent of revenue (Figure 1, left pillar).

Expenditures

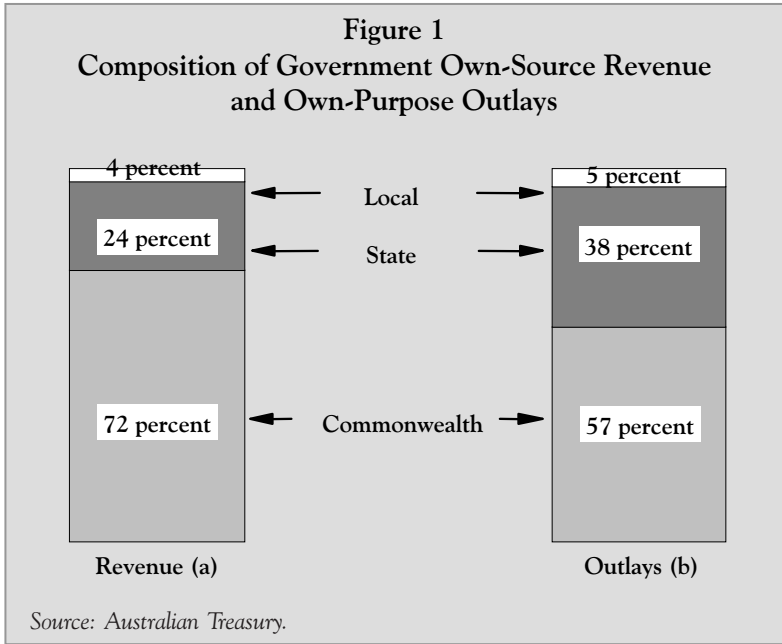
The structure of expenditure differs markedly between levels of government. For the federal government, more than one third of total expenditures is on social security payments. Other significant own-purpose expenditures occur in the areas of debt servicing, defense, and general public service. The states are responsible for expenditures on education, health, and the police. The largest expenditure category is education, followed by health, with the largest outlay for hospital funding. Other significant areas of state outlays are for debt servicing and transport (road and rail). Transport infrastructure and housing, as well as recreational and cultural amenities, are in the realm of both state and local governments. Public servants' salaries are paid separately by each level of government for its employees. The expenditure that the states make to meet their responsibilities account for 38 percent of total government outlays, which far exceeds their revenue raising capacities. By contrast, the central level accounts for 57 percent of expenditures for central level functions, which is much less than its share in total revenue (Figure 1, second pillar).

Vertical fiscal imbalance

The persistent mismatch between the revenue raised and expenditure undertaken at the federal and state government level is called vertical fiscal imbalance (VFI). If the imbalance cannot be remedied by changing the assignment of taxes and other sources of revenue, then a system of intergovernmental fiscal transfers is necessary. This is the case in Australia (James 1992).

Horizontal fiscal imbalance

Horizontal fiscal imbalance (HFI) arises when governments at the same level have different per capita capacities to raise revenue and unavoidable differences in their per capita costs of providing services. Such differences occur naturally between states that differ in their structural characteristics. The extent of HFI between states in Australia is probably lower on average than in many other countries, and certainly lower than in



Indonesia. The major states do not differ too much in structure; each has one or more metropolitan centers, some service manufacturing and heavy industries, and contains a significant rural area under agriculture.

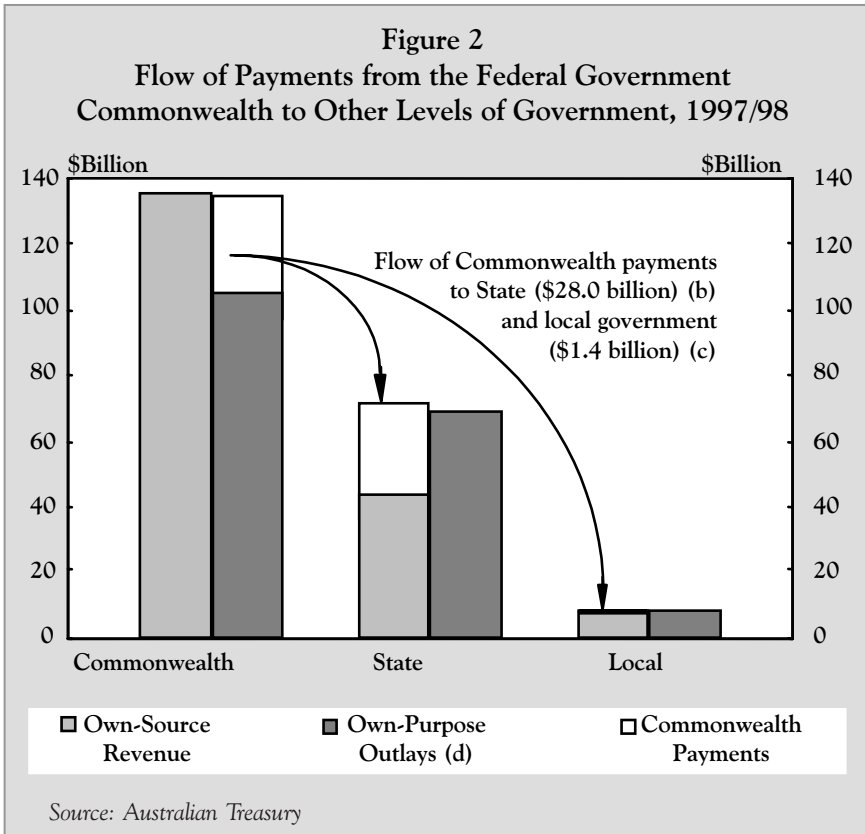
HFI is defined not in terms of actual revenue raised and cost of services provided, but on the basis of the *potential* of state governments to raise revenue and to provide services (Searle 1996). *Actual* revenue and outlays depend on each state's

- structural characteristics,
- policy on public spending and taxation (high or low levels of service, provision and tax rates), and
- efficiency of service provision and revenue collection.

Intergovernmental Fiscal Transfers

The Australian fiscal transfer system has to overcome a high degree of VFI and at the same time aims to remedy HFIs between the states. The main instruments are specific grants (specific purpose payments, SPPs) and block grants (general revenue grants) from the federal to the state and local governments. In the financial year 1997/98, total transfer payments

from the central level to the states and local governments was Australian dollar (\$) 29.4 billion. Of this, just over half was in the form of block grants, and about one third as SPPs. The rest is made up of specific grants paid through the states (to be handed on to universities, local government, etc.) and some direct payments to local governments.



Specific grants

SPPs are meant to enable the federal government to pursue national objectives in areas that are part of the states’ fiscal responsibilities. SPPs can be used to capture spillover effects between states, support standardization, provide seed money, and channel expenditure through the states in activities that are better performed by state administrations. Examples are interstate roads, higher education, and support programs for indigenous people, all of which might not receive adequate state funding from a national point of view. SPPs are generally unpopular with the states

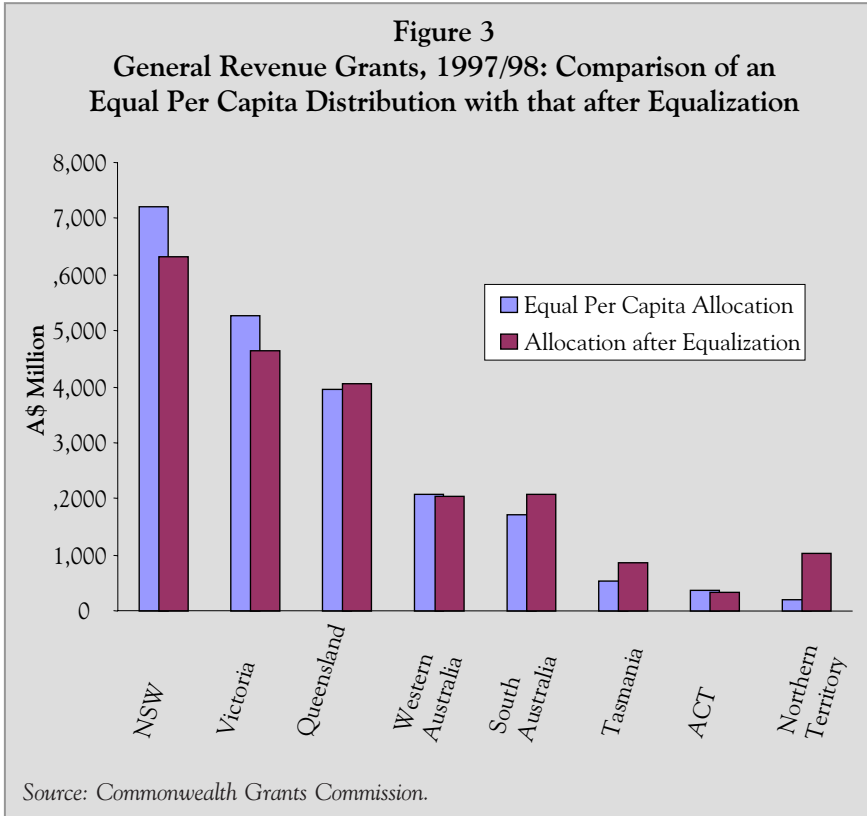
because they are seen as an intrusion of the central level in functions that are constitutionally assigned to the states. SPPs are paid both directly to the states and through the states, which means that state governments pass the funds on to local governments and universities. The largest functional category is health with A\$6 billion, followed by education. Other important categories for SPPs are housing, social security, and transport.

Block grants

Block grants (general revenue grants) are paid without any conditions on their use by the states. They are used to remedy any remaining VFIs and to address HFIs by allocating different per capita shares to individual states. All states receive payments, but the per capita amounts differ. The allocation system for these grants is examined in detail below.

The total pool of block grants is principally a matter of negotiation between the federal and state governments. For the last few years it has been indexed to inflation, so the real level of block grants has remained the same. After the tax reform, the pool will consist of the revenue generated by the value-added tax, which will rise with the growth of the economy (Australia 1998b).

Figure 3 shows the distribution of general revenue grants between the States and the effect of differentiating the per capita payments to remedy HFIs. New South Wales and Victoria, the two most populous states, get much less in block grants than they would if the money were distributed on an equal per capita basis. For example, in the last financial year New South Wales received A\$6.3 billion in general grants, but would have received A\$7.2 billion if there were no horizontal fiscal equalization. South Australia, Tasmania, and the Northern Territory receive substantially more than their equal per capita share. The Northern Territory receives A\$1 billion instead of A\$0.2 billion. For the other states, the effects of horizontal equalization are not very large.



Fiscal Equalization through Block Grants

The principle of fiscal equalization

The principle of horizontal fiscal equalization applied in Australia is that “each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.” (Commonwealth Grants Commission [CGC] 1998a).

There are three crucial aspects to this definition. First, fiscal equalization aims to achieve equal *capacity* among the states to provide public services, not equal results. It is left to the states to determine how much service they provide, how efficiently they provide it, and how much own revenue they raise. Second, using Australia-wide *averages* as the reference means that no particular level of services and taxes is prescribed. The standard is defined by what the states actually do, not by what some

authority might consider to be the correct spending level. Lastly, the states are free to decide what kind of services they provide, and in which manner.

Consequently, a state's policy choices do not directly affect the amount of revenue assistance it receives. Horizontal equalization is based solely on differences in the structure of the states. For example, if a state opts for lower tax rates, the shortfall in revenue will not be made up by increased fiscal transfer payments from the Commonwealth. That state will have to provide less services to its residents, provide them more efficiently, or borrow. By contrast, if equalization were based on performance rather than capacity, or on external standards rather than averages, then judgements would have to be made on the correct level of services and tax rates to determine transfer payments.

It is one of the principles of the Australian federation that states should be free to pursue individual policies in the fields of their responsibility. The design of the fiscal equalization system is in keeping with this principle. However, the fact that the states have only a limited range of taxes they can levy and regulate means that the leeway for differentiation in taxes is small. In practice, the states do not differ very much in their tax structure. Differences in service provision are larger.

Equalization in practice: the result

The pool of general revenue assistance is distributed between the states to achieve horizontal fiscal equalization according to the principles set out above. Each year an independent authority, Commonwealth Grants Commission CGC (see Appendix 1 of this book for description and interview), determines the grants allocation per capita in each state (CGC 1998a).

The allocation of block grants is determined by each state's costs of service provision, revenue-raising capabilities, and receipt of SPPs relative to the average of all states. The distribution of grants is determined by these three factors (for details see below). Starting from a hypothetical equal per capita distribution across the states, the amount paid per capita (Table A3.1, column [1]) is adjusted for expenditure needs, revenue needs, and receipt of specific grants.

As can be seen from the Table, the grants for New South Wales for example are adjusted downwards because of lower cost of service provision

Table A3.1
Disaggregation of 1997/98 General Revenue Grants Distribution

Province	Equal Per	Expenditure	Revenue	Per Capita	Per Capita	Per Capita	Per Capita	Total
	Capita	Needs	Needs	Adjustment	Adjustment	Adjustment	Adjustment	(6)
	(1)	(2)	(3)	(4)	(4)	(4)	(5)	(6)
	\$ p.c.	\$ p.c.	\$ p.c.	\$ p.c.	\$ p.c.	\$ p.c.	\$ p.c.	\$ m
New South Wales	1,145.39	-60.52	-97.26	17.48	1,005.09	1,005.09	1,005.09	6,326.1
Victoria	1,145.39	-228.97	68.02	23.82	1,008.26	1,008.26	1,008.26	4,639.5
Queensland	1,145.39	-24.08	40.04	8.89	1,170.24	1,170.24	1,170.24	4,046.2
Western Australia	1,145.39	251.62	-196.25	-75.57	1,125.19	1,125.19	1,125.19	2,037.1
South Australia	1,145.39	65.35	202.65	-14.02	1,399.38	1,399.38	1,399.38	2,082.5
Tasmania	1,145.39	254.05	406.08	-29.47	1,776.05	1,776.05	1,776.05	840.8
Australian Capital Territory	1,145.39	-178.17	88.48	33.90	1,089.61	1,089.61	1,089.61	339.2
Northern Territory	1,145.39	4,886.89	-28.87	-485.01	5,518.41	5,518.41	5,518.41	1,016.5
Australia	1,145.39	0.00	0.00	0.00	1,145.39	1,145.39	1,145.39	21,327.9

Source: Commonwealth Grants Commission.

(expenditure needs, -A\$60.52 per capita) and higher revenue-raising capability (revenue needs, -A\$97.26 per capita), but adjusted upwards because of lower-than-average receipt of SPPs from the federal government (adjustment for SPPs, -A\$17.48 per capita). The net effect is a lower-than-average amount of block grants per capita. The disaggregation also shows that the favorable treatment of the Northern Territory is entirely due to higher expenditure needs, while the high level of specific grants substantially reduces the amount of general revenue assistance to the Northern Territory.

The grant allocation tends to be higher for the less populous states. The more densely populated eastern states of New South Wales and Victoria have the lowest allocations, while the Northern Territory with its extremely small and dispersed population and particular socioeconomic structure (high share of aboriginal population) receives a disproportionately high share. Payments of block grants per capita to the Northern Territory are almost five times as high as in the national average. The allocations have changed over time, both because of changes in the structure, expenditures, and revenue of the states, and because of changes in the assessment methods. The overall pattern in the distribution of funds however has remained stable.

Equalization in practice: the methodology

CGC has developed an elaborate methodology to determine the allocation of general revenue grants. At the core is a comprehensive assessment of disabilities in revenue-raising capacity and expenditure needs for each state relative to the average of all states.

If a state raises less (or spends more) than the average, this is due either to a deliberate policy choice, less efficiency in revenue raising (or service provision), or structural factors (called disabilities). A *disability* is defined as “an influence beyond a government’s control that requires it to spend more (or less) per head of population than other governments to achieve the same objective, or reduces (or increases) its relative capacity to raise revenue from the same effort” (CGC). Fiscal equalization is concerned only with disabilities, not with the effects of policy choices or administrative efficiency. Revenue and expenditure needs can be either positive or negative, depending on whether structural characteristics put a state in an unfavorable or a favorable position relative to the Australian average. Table A3.1 details revenue and expenditure needs due to disabilities.

Expenditure assessment

Expenditure assessment is at the core of the Australian fiscal equalization system. CGC currently determines the cost and level of service provision in a total of 49 categories. The assessment is thus very detailed; education expenditure for example is analyzed in seven separate subcategories (Table A3.2).

Table A3. 2
Categories for expenditure assessment (1998)

Education

Preschool education, government primary education, nongovernment primary education, government secondary education, nongovernment secondary education, technical and further education, transport of rural children

Health

Hospital services, nursing home services, mental health services, community health services

Law, Order, and Public Safety

Police, administration and justice, corrective services, public safety and emergency services

Welfare

Family and child welfare, aged and disabled welfare, other welfare services

Culture and Recreation

Culture and recreation, national parks and wildlife services

Community Development

Planning and environment, aboriginal community services

General Public Services

Superannuation, other general public services

Services to Industry

Agriculture and fisheries, Brucellosis eradication, mining, fuel and energy, tourism, soil conservation, other services to industry

Transport

Road maintenance, other transport

Economic Affairs and Other Purposes

Debt charges, other services

User Charges

Technical and further education user charges, hospital patient fees, fees and fines, property titles, other user charges

Trading Enterprises

Urban transit, nonurban transit (freight), nonurban transit (passengers), country water supply and sewerage, country water supply and sewerage user charges, housing, housing user charges, other trading enterprises

Source: Commonwealth Grant Commission.

Expenditure assessment consists of three steps: (i) examining the characteristics of each state's population, economy, and physical environment; (ii) determining whether and how these characteristics influence the need for or the cost of public services; and (iii) deciding whether there are disabilities. Analogous to revenue assessment, the result is *expenditure needs*, which is the difference between the per capita amount a state needs to spend to provide the standard level of services and the Australian average per capita expenditure.

The cost of providing public services depends mainly on socio-demographic and geographic characteristics. Examples for such structural factors are the relative number of school-age children (education), the relative number of aboriginals (health), and the population density and dispersion (various services). Taking the subcategory road maintenance as an example, the Northern Territory is assessed to need 2.3 times as much money per capita of its population than the national average to provide road maintenance of the average Australian quality. This is because the Northern Territory has a very low population density that results in a high road length per capita, and because it is costly to maintain roads in remote parts of the state. If the policy of the state government is to provide road maintenance at below or above average quality, this does not affect the assessment. The Northern Territory has much higher-than-average costs of service provision in almost all expenditure categories, which is the reason for the very high assessed expenditure needs of A\$4887 per capita (Table A3.1, column [2]). As can be seen in the Table, expenditure assessment has a significant impact on the distribution of grants.

In many cases, the definitions of disabilities and what might be suitable indicators are debatable, and some necessary data are not readily available even though the Australian statistical system is comparatively comprehensive. The question of which expenditure categories should be included in the assessment is an issue of debate between the states, too. Such difficulties tend to affect the assessment of expenditures more than that of revenue. Consequently, the work of CGC requires a great deal of judgement as well as thorough economic and statistical analysis. This part of CGC's work uses up substantial resources.

Revenue assessment

For each state, CGC determines the revenue raising capacity and the revenue raising effort for 20 revenue sources, of which 14 are taxes and 6 are nontax revenues (Box A3.1).

For each revenue source, indexes are calculated by putting each state's assessment in relation to the Australian average. The results of the categories are then weighted with their share in average expenditure to yield aggregate revenue needs.

The results of revenue assessment can be expressed as *revenue needs*, defined as the difference between the per capita amount a State needs to spend to provide the standard level of services and the average Australian per capita expenditure. Revenue needs can be positive or negative. This is the measure presented in Table A3.1, column 3. Revenue-raising capacity depends on the available revenue base. In the assessment of revenue capacities it is not relevant whether a revenue source is actually levied in a particular state, at what rate, and how efficiently. Differences in revenue bases between states can be due to differences in the structure of industry and demand, the value of property, natural-resource availability, and so forth.

An example for a characteristic that affects revenue disabilities is mining revenue, which consists largely of royalties. The assessed revenue raising capacity for Western Australia and the Northern Territory in this category is around four times as high as in the Australian average. This is because these states are rich in minerals and have a large area per capita. By contrast, the revenue capacity in mining is assessed lower than average in the more populous states, where mining plays a less important role.

Box A3.1
Categories for Revenue Assessment (1998)

Taxes

Payroll taxation, land revenue, stamp duty on conveyances, financial transaction tax, stamp duty on shares and marketable securities, gambling taxation, insurance taxation, vehicle registration fee and tax, stamp duty on motor vehicle registration and transfer, drivers' license fee, tax (business franchise fees) on petroleum products, tobacco and liquor, other tax revenue.

Nontax revenue

Interest earnings, mining revenue, electricity and gas, metropolitan water supply, metropolitan sewerage, other enterprises.

Source: Commonwealth Grant Commission.

Adjustment for specific grants

The fact that SPPs from the Commonwealth to the states are at a relatively high level presents a difficulty for fiscal equalization. The receipt of a specific grant changes both a state's revenue and its expenditures. It is debatable however to what extent SPPs represent disabilities according to the definition above. To achieve full equalization, other grants received from the federal government need to be counted as revenue. However, this runs counter to some of the intentions behind specific grants because the recipients of SPPs are subsequently punished by receiving less in block grants. However, there is no evidence yet that any state has refused a specific grant offered to it for this reason. This may be because CGC bases all its assessment on a period of five years, averaging out year-to-year fluctuations. The money received through SPPs thus reduces block grants only after a lag of several years.

CGC is now including most SPPs in the calculations, so that differences in the per capita allocation of specific grants between states are almost fully compensated by the allocation of block grants. The adjustment for SPPs has the effect that the states that benefit from equalization receive slightly less than they would if SPPs were excluded (Table A3.1, column [4]). This is because the states that need more financial assistance generally also receive more specific grants.

CONCLUSION

The Australian grants system is a technically sophisticated way to address vertical and horizontal fiscal imbalances. However, it has to be kept in mind that the system of intergovernmental fiscal relations in Australia exists in a very favorable environment. The nature of relations between the federal level and the states, and to a certain extent between states, is generally cooperative. The Australian federation as a whole is relatively homogenous and stable. The small number of States and the fact that there are only two levels of government that are important fiscally, help to make the system workable. Applying the same principles in a different environment may not be possible politically, or may not yield similar results.

Regarding the technical implementation of fiscal equalization, the Australian example shows that it requires a substantial amount of technical resources. Australia has a sophisticated statistical system both on the national and the regional levels, which is essential for equalization. Even

with this superior statistical base in a relatively small country, CGC is quite a large organization, taking up substantial resources. It is far from clear how a similar system would perform under less favorable conditions. In Indonesia, a similar system of fiscal equalization would probably be only feasible if the assessment of revenue and expenditure were restricted to some core categories.

Studying intergovernmental fiscal relations in Australia can provide important insights and ideas for reform in Indonesia. Ultimately however each country needs a system tailored to its specific requirements.

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Appendix

THE COMMONWEALTH GRANTS COMMISSION Background and Interview with Bob Searle, Secretary of the Commission

The Commonwealth Grants Commission (CGC) is an independent statutory authority that provides advice to both the Commonwealth and state governments on the distribution of the pool of general revenue assistance. It is only concerned with the distribution, not with the total amount of block grants paid to the states. The size of the pool is negotiated annually between the federal and state governments.

CGS's motto is "equality in diversity," expressing the aim of providing states with equal financial capacity while leaving them free to make their own decisions on taxation and service provision.

CGC was established in 1933, in the wake of the attempted secession of Western Australia, to assess claims made by states for financial assistance. It was thus concerned only with claimant states' minimum financial need, not overall fiscal equalization. The role of CGC changed and was expanded with the introduction of general revenue-sharing arrangements in 1976 that necessitated the calculations related to horizontal fiscal equalization. It conducts a full review of relative attributes (relativities) and the methodology used to calculate them at five-year intervals. In between these reviews, the relativities are updated annually, using the latest available data but retaining the same methodology. CGC does a substantial amount of statistical analysis, and it even conducts some original data collection, mainly in the area of expenditure assessment.

The commission is headed by four part-time members who are appointed for a limited period by the federal government after consultation with the state governments. The commission has a permanent staff of around 50.

Overall, CGC is considered an integral part of Australia's federal structure, with an important role in promoting fiscal and political stability between the state governments and the Commonwealth government. It can be credited with fulfilling its role as a competent technical advisory body, in effect acting as an impartial arbiter between state governments.

Interview with Bob Searle, CGC, Canberra, 10/12/98

How many out of the 50 staff of the Commonwealth Grants Commission are technical?

All but four or five of the 50 staff work in a technical environment, their background mainly being in statistics, economics, and accounting.

How important is technical work relative to negotiating the state's interests?

The Commission is not involved in any negotiations with the states. All its work is on technical aspects of fiscal equalization.

How close is the cooperation with the states?

The states are involved in the technical aspects of the Commission's work, and there is communication with the states at all stages of the process of determining the relativities. The states are particularly involved in the reviews of methodology, to a lesser extent in the annual updates.

With which state institutions does the Commission have contact?

The states communicate with the Commission principally through their state treasuries. All other arms of government channel their participation through the treasuries. Submissions are the main instrument for the states to put their arguments forward. There is a formal process for these submissions to the Commission, and states also comment on each other's submissions. The Commission also has some contact with other state departments, for example, education, health, and police. This is important for expenditure assessment.

How closely does the Commission keep the states informed of its work?

In the three years leading up to the review of methodology to be published in February 1999, there have been approximately eight conferences with the states on technical matters. The Commission also produces detailed working papers on past assessments. These were originally exclusively for the use of the states but are now distributed to reference libraries also.

Do the states have an influence on Commission methodology?

Yes, they do. It is necessary to find a basis of assessment which is fair to all states. The most important influence the states wield is by proposing areas to be used to identify disabilities.

Do the losers accept technical arguments?

There is general consent on the technical ability of the Commission. Whether states agree on particular assumptions underlying the relativities calculations in another

matter. Generally speaking however, the states are very accepting of the Commission's judgements. They know that they are dealing with an expert body, and that they themselves could not do it any better.

How does the appointment process for the Commissioners work, and is there proportional representation in terms of party politics?

Commissioners are appointed for their particular expertise rather than their representational role. The only condition is that the commissioners cannot be full-time employees of a state or the federal government, since they might then be seen as being biased.

What happens in the appointment process is that the heads of the Commonwealth and state treasuries get together and consider names. It is a cooperative movement—if any of the parties involved has an objection to a particular candidate, that person will have little chance of becoming a commissioner.

Have there been swings in the Commission's position on equalization?

No. The Commission developed the concept of fiscal equalization in the 1930s. There has been a development process over time, but as for changes in the federal government, there has been no political involvement.

The Australian parliament is currently debating a tax reform proposal. It includes the introduction of a value-added tax levied by the central government, the revenue of which will be distributed to the states. Will there be changes in the Commission's role after the tax reform?

There will be very little difference for our work. The revenue from the new value-added tax will be distributed to horizontal fiscal equalization principles, and the Commission will continue to determine the equalization formula. The only difference is that the states will have less own revenue, because they will have to stop levying some of their taxes.

From the Commission's point of view, should there be less specific grants?

The Commission is not concerned about the extent of special purpose payments, as long as they can be included in the Commission's assessment. Currently, they are accounted for in the calculation of relativities and do not negatively affect horizontal fiscal equalization. In fact, SPPs can serve good purposes, and the Commission acknowledges that.

From the point of view of the Commission, would it be desirable if the Commission had influence over the amount of general revenue to be distributed, too?

That really has never been a concern. For horizontal fiscal equalization, control over the amount of funds to be distributed is not necessary, as long as the level of funding available is high enough. That is of course the case.

We deliberately do not see ourselves as giving economic policy advice, such as on the total amount of grants payments. Otherwise, we might be seen as an arm of government. We need a high level of independence for our work.

Can or should the Commission be a model for other countries?

I think all federations are different, so they should have different systems of fiscal transfers and equalization. There has been a continuous stream of interest from other countries in the Australian system, and it has frequently been studied. That probably speaks for itself.

Can the Commission assist countries that want to reform intergovernmental fiscal relations, and how?

We frequently have officers from other countries visiting, and some are staying with us for some time. The topic they usually focus on is expenditure equalization. Our involvement is through technical cooperation programs, organized by international agencies such as the World Bank and the IMF, or AusAID.

What are the most recent examples for technical assistance to developing countries?

South Africa has modeled its new system of intergovernmental fiscal transfers on the Australian system. The ANC had contacts with us even before Mandela was elected. After the election, members of the South African commission came here.

More recently, China has initiated an international search for suitable models of intergovernmental fiscal relations, and is now concentrating heavily on the Australian system.

Annex IV

THE PILOT INTERGOVERNMENTAL
TRANSFER SCHEME OF 1995-1996
IN THE PEOPLE'S REPUBLIC OF CHINA¹

A transitional transfer payments scheme was introduced in 1995 as the first step toward a formula-driven redistributive system. The initial formula had two parts: an objective factor that attempts to measure the gap between standard expenditures and local fiscal capacity, and a policy component that directs subsidies to regions with large ethnic minority populations. In 1996 a third factor was added to the formula to reward good tax effort. Since then more tinkering has been done.

The 1996 formula for transfer was as follows

Transfer to province i = f(measured fiscal shortfall of province i) + g(special transfer to province i as a minority region) + h(province i's good tax effort)

The fiscal shortfall is measured as

Standard expenditure = standard wage expenses + standard administrative expenses + agriculture and other productive expenditures + other expenditure

where

- *standard wage expenses* are derived from standard wages, number of civil servants, and a regional wage factor;
- *standard administrative expenses* are those for government administration, police and security, and other government agencies. In 1995 the actual expenditures for all government units were included. In 1996 this was shifted to include personnel and running costs for fully funded units, and lump sum costs for units that received only partial funding from the budget.
- *agriculture and other productive expenditures* are expenditures for agriculture and other productive departments.
- *other expenditure* includes price subsidies.

¹ World Bank.1998. Managing Public Expenditures for Better Results. Washington, D.C. Annex 9.

The policy component, or special transfers to province *i* as a minority region, also calculates the fiscal gap between the minority regions and the national average as

$$(NR - PR_i) \times POP_i$$

where

NR = national per capita revenue; *PR_i* = province *i*'s per capita revenue;
POP_i = population of province *i*

The coefficients *a₁* and *a₂* are determined ex post, as the ratio of funds available for transfer divided by the size of the gap. For example, in 1996 the central government had Y2.2 billion to devote to equalization transfers, compared with a fiscal gap of Y63 billion. So *a₁* was derived as 0.035. Similarly, the total fiscal gap for minority regions was estimated at Y13 billion in 1996, while the amount allocated to filling the gap was only Y1.2 billion in the central budget; the coefficient *a₂* was derived as 0.09.

Finally, the tax effort reward was derived in 1996 as follows: if province *i* had revenue growth in 1995 that exceeded the national average, then the total transfer to province *i* would be supplemented by the coefficient *a₃*, where

$$a_3^i = 0.5 \times (r^i - r)$$

and

rⁱ = revenue growth of province *i*

r = national revenue growth

so that

$$(\text{Transfer to province } i)_t = \{(1 + a_3^i) \times [a_1 \times (\text{standard expenditure}_i - PR_i \times POP_i) + a_2 \times (NR - PR_i) \times POP_i]\}_{t-1}$$

and *t* = current year, *t* - 1 = previous year

In other words, the transfer to province *i* for 1997 will be based on its fiscal gap and tax effort in 1996. The system should be recognized as transitional and does not obviate the urgent need to get a more appropriate transfer scheme installed.

Recommendations for Improving the Pilot Scheme

For the transfer scheme to be effective, it must be more adequately funded. The scheme was allocated only Y2 and 3.46 billion in 1995 and 1996, respectively. These comprised just over 1 percent of the total of nearly Y300 billion in central transfers to the provinces in 1996 and was dwarfed by the tax rebates of Y195 billion. Because of the small sums allocated, their effect on the distribution of fiscal resources is marginal: the coefficients a_1 and a_2 are very small, so that the scheme provides only a very weak link between a province's fiscal need and their transfers.

At present the scheme mixes two sets of considerations: fiscal need and support for ethnic minority regions. These objectives should be kept separate, with one equalization scheme that provides transfers according to need (plus a tax effort factor), and the other scheme to support ethnic minorities reported separately. The total of Y3.46 billion spent on the pilot scheme in 1996 was in fact split into Y2.2 billion for the equalization scheme, and Y1.2 billion for the minority's scheme.

The transitional scheme duplicates the old pre-1994 equalization transfers under quota subsidies, which totaled Y11.1 billion in 1996 and were heavily biased toward minority regions. These schemes should be merged as soon as possible—if the pilot scheme is considered an improvement over the quota subsidies, then it should simply absorb and replace the quota subsidies.

The tax effort measure takes the gap between national revenue growth and the provincial revenue growth. This is a convenient proxy that should be replaced by better measures as better data become available. Provincial revenue growth depends on too many factors other than tax effort, most notably economic growth and structural change.

Finally, it is urgent that the pilot transitional scheme be replaced by a model that measures fiscal needs more appropriately. At present, the measured fiscal gap only considers the personnel and running costs of government, with wage costs weighing heavily. This reflects the short-term concern in meeting payroll requirements. In the long run, however, it is more appropriate to look at fiscal needs in terms of the costs of providing services such as education, health care, government administration, public transport, water, sewerage, and sanitation services. This package of fiscal needs should contain not only wages and running costs but also some capital

costs for building schools, clinics, roads, etc. Regional cost differentials in providing these services must also be included in the calculation of fiscal need—the present regional factor contains only a small differential for wage supplements and is insufficient.

NOTES

- ¹ See Shah (1994) and Ter-Minassian, ed. (1997).
- ² See Prudhomme (1994).
- ³ Drawn in part from Bahl (1999), Ebel and Yilmaz (1999), and Prud'homme (1994).
- ⁴ This section and the following are drawn from a number of authors: Rodden (2000), Ter-Minassian (1997), Bahl (1998, 1999), Shah (1998), Bird and Wallich (1993), Wallich, ed. (1994), Ebel and Yilmaz (1999).
- ⁵ Bird and Wallich (1993).
- ⁶ See McLure (1998), cited in Bahl (1998).
- ⁷ Problems have however been experienced in the US where subnational governments regularly raise tax rates during periods of economic contraction, thus worsening the situation.
- ⁸ US cities compensate for this by levying local income tax on commuters as well as residents. In Russia, the personal income tax is fully returned to the local government of the place of employment and none to the place of residence. As labor mobility increases and housing becomes less scarce, this will become a significant problem with personal income tax sharing in Russia.

Chapter 9

Acquiring Goods and Services: Public Procurement

Where there is honey, there are bees.
– Nepali proverb

Besides financial resources, discussed in the two previous chapters, and labor, discussed in the next three, government needs a variety of equipment and materials, as well as consultants and other services, to perform its activities. The acquisition of these goods and services is normally referred to as procurement.

NATURE AND SCOPE OF PUBLIC PROCUREMENT¹

Government procurement is the acquisition of goods, services, and public works in a timely manner that results in best value to the government and the people. The performance criterion for evaluating procurement activities is economy, i.e., acquisition at the lowest price without sacrificing quality and timely delivery. Public procurement gives substance to the tasks of government. A major proportion of public expenditure at every level of government is incurred through the procurement of goods and services and construction activity. Typically, procurement accounts for 20 percent of central government expenditure, and up to 50 percent of public expenditure in developing countries (including construction contracts). The range of government contracting and purchasing is vast, from weapons systems and large industrial plants to raw materials, paper and milk, custodial services, etc. Poor procurement management has an impact beyond project implementation and the functioning of the public agency concerned. It also delays or dilutes the intended program benefits to society, constrains private sector performance, and is commonly perceived to be associated with bribes for the award of contracts. Consequently, procurement and public works engage the attention of a significant number of civil servants and

political leaders throughout the year, and the ex-post scrutiny of auditors and legislators.

Historically, the role of the public service was to procure goods and services for the king. Samuel Pepys was appointed in the 17th century by the British monarch to look into the reasons why the quality of ships and supplies for the British Navy was so unreliable, and prices so high (Box 9.1).

Box 9.1
Procurement Function in 17th Century England

... But I see it is impossible for the King to have things done as cheap as other men.
- Samuel Pepys, 1662

The diary of Samuel Pepys gives a striking description of the procurement function in 17th century England and the uncontrolled scope for self-enrichment by government officials in those times. Pepys managed to clean up the defense procurement process for the King by delving into administration as a professional, learning about what was required by the navy and why, negotiating fiercely on quality and price, and following up to see that contracts were properly fulfilled. He was troubled by the ease with which he (like many others before him in his position) could receive “tokens” of appreciation from successful contractors. On occasion, Pepys himself yielded to the temptation.

The diary also speaks about the required reporting on procurement to the increasingly assertive Parliament in its watchdog role, and the type of meticulous documentation that was needed to justify the conduct of the executive.

Source: Richard Latham. 1978. The Illustrated Pepys. London: Bell and Lyman.

Public procurement includes procurement by government and by statutory boards and nonministerial bodies as well. Often, the purchase of goods and services by nongovernment public entities is far greater than that undertaken by ministries and reflected in the budget. These entities follow regulations similar to those of ministries, and are subject to government audit in their use of funds. Procurement in the broad sense also covers issues of procurement strategy, storage, distribution, contract monitoring, and supplier management, and is thus synonymous with total supply chain management. The purchasing phase of the procurement cycle involves selecting suppliers, negotiating, and contracting for goods and services.

Contracting for public works and construction is usually treated separately from purchase of goods and services for a number of reasons.² Unlike goods and services that go into the consumption stream or serve as intermediate inputs, public works (roads, bridges, buildings, etc.) represent tangible final outputs. The standards and specifications for construction tenders and contracts are also different, and the contracting process lends itself to the unbundling of the project, and thus to separate contracts for each component (e.g., design, technical services, and actual construction). The process accordingly stretches over a much longer period than the procurement of goods and services, and calls for closer and continuous supervision.

As a part of the broad procurement process, contracting out in some countries has become more prominent. Contracting out the delivery of services, such as transport and garbage collection, has been common for years, but has increased in use since the late 1980s, at both national and subnational levels of government. (Contracting out is discussed in Chapter 13 on “exit” mechanisms.)

Procurement can be centralized or decentralized in different degrees. Central purchasing agencies continue to function in many countries; often prompted by the fear of waste and abuse of power by field offices. Genuine decentralization, as discussed in Chapter 5, would imply the autonomy and flexibility of subnational units to procure goods and services either under centrally financed programs or as an agency function carried out on behalf of the central government. Standards and criteria, however, should still be set at the central government level. Similarly, central procurement operations are generally to be carried out by the ministry or agency concerned, but under policy, guidelines, and oversight by a central procurement entity.

It is useful to distinguish between international and local procurement, and between large or complex purchases and routine procurement of daily supplies. These distinctions have practical implications for the manner of organizing the procurement function, the form of the bidding required, and the scope for decentralization and delegation.

There are essential differences between the procurement process in the government and that in a private firm. A private firm places less emphasis on formal competitive bidding, documented procedures, and constraining conflicts of interest than governments do. Private managers have built-in

incentives to purchase goods that provide high value for their price, and to hire contractors who will accomplish high-quality jobs at competitive prices. The dimensions of accountability are related to results, not process, because in the private sector the results are more easily quantifiable, by reference to their impact on overall company profit.

In contrast, the public manager must follow prescribed competitive procedures, and the rules give a major weight to fairness and equity. Also, public procurement is subject to oversight by the legislature and audit (in addition to internal accountability mechanisms). Mistakes or malfeasance in public procurement can have vast political repercussions, owing to the focus that the media and the public place on the subject.

Also, private firms and nonprofit agencies prefer stable relationships with suppliers and long-term contracts, for certainty and easier business planning, but several factors (including the fear of collusion with contractors and financial rules) prevent public agencies from developing such long-term relationships. Finally, public procurement is often used as a tool for public policy goals (e.g., fostering the growth of local industry, or benefiting groups of poor women or disadvantaged groups).

OBJECTIVES OF PUBLIC PROCUREMENT

Economy

As noted, the criterion of “economy” (which is common to both public and private procurement) involves acquiring goods and services of defined specifications on a timely basis and at the lowest cost. Economy is a useful criterion for administrative purposes, as it is linked to the performance of the procurement function. However, from an economic point of view, it is subsumed under the broader criterion of *efficiency*, i.e., lowest *unit* cost of production: if the goods and services to be procured are not the appropriate ones for efficient production, procuring them at least cost is no advantage.

Wasteful procurement can arise from duplication and overlap in government operations, from a lack of predictability in the flow of funds to public agencies (which leads the agencies to use the funds available when they happen to be available, entailing higher cost of storage), and from a lack of incentives for employees to make the best use of supplies. Sound procurement, therefore, depends also on a variety of organizational

and incentive factors within government well beyond the control of those in charge of the procurement function itself.

Import Substitution

The government procurement strategy may deliberately encourage the growth of local industry by giving preferences to local suppliers or restricting purchases from foreign firms. Many governments seek to ensure some advantage for domestic industry in competing for the business of public organizations. These preferential practices must be kept carefully distinct from regulations intended to offset market imperfections that prevent domestic suppliers in developing countries from competing on a fair and equal basis with international suppliers. Unlike those regulations, preferential procurement practices may well be inadvisable from both an efficiency and a development viewpoint.

Some preference to domestic firms in international competitive bidding has traditionally been recognized by donor agencies, e.g., the World Bank. The European Union (EU) allows countries applying for membership (from central and eastern Europe) to keep domestic preference provisions, but only for a limited time. The rules of the World Trade Organization (WTO) call for uniform treatment of domestic and foreign suppliers in procurement. However, WTO provides for special and differential treatment of developing countries to safeguard their balance-of-payments position, promote the development and establishment of domestic industries, and support industrial units that are substantially dependent on government procurement.

Fostering Competition

Competition in procurement is defined as equality of opportunity for qualified suppliers to compete for public contracts. Competition and impartiality are needed not only to ensure a beneficial outcome in price and quality, but also to promote public accountability in the process. Increasing competition in public procurement is a goal of most governments, and is supported by international organizations as well. In the United States (US), for example, the Competition in Contracting Act of 1984 aims to increase competitive efforts within departments and to narrow the justification for sole-source (direct selection) contracting. Countries like the United Kingdom (UK) require their local governments to resort to compulsory competitive tendering for all purchases and services. Many

countries require their national and subnational governments to increase their use of open bidding, improve the handling of competitive bids, and streamline administration and payment procedures, to attract more firms to compete for government business. Because the number of qualified suppliers is directly related to the degree of competition, many developing countries and most aid agencies support the provision of information and technical assistance to bidders to better understand the rules of procurement and become qualified to compete.

In developing countries, competition is often restricted by market imperfections such as barriers to entry and information gaps for small and less experienced suppliers. These barriers are sometimes put up by the administrative process itself, such as the tendency to float large bids to have a single centralized decision, or the expensive or formalistic overspecification of requirements that small and less experienced firms find very costly to fulfill. In some areas, e.g., emerging technology, specialized services, or complex equipment (as in military procurement), aid-dependent developing countries may be obliged to deal with only one or two bidders because the government is often restricted to choosing only from the donor country's suppliers. The long-term strategy is to encourage the development of the domestic contracting industry through various means, to lower the barriers to entry for small business and voluntary agencies, and to untie aid as much as possible through better cooperation among donors and stronger leadership by the multilateral financial institutions in this respect.

The Governance Dimension

Predictability, a key principle of good governance, presupposes consistent principles and regulations for procurement, qualification of contractors, award of bids, and contract management. Information and documentation on these rules should be widely available, and the rules should be enforced fairly and consistently. Predictability in procurement also requires a well-understood system for registering and resolving complaints speedily, a well-functioning system for dispute settlement, and checks on the arbitrary behavior of procurement managers and on the inconsistent exercise of discretionary power in contract award, enforcement, and management.

Accountability and transparency are vital to procurement management as well. Lack of oversight mechanisms to ensure accountability undermines the capacity of governments to secure the confidence of

contractors in the public procurement process and the trust of citizens in the proper use of that public funds. Trust and confidence can be especially eroded by secrecy in procurement transactions, especially at the local levels (although a degree of confidentiality is essential to protect business privacy and the legitimate interests of individual bidders). Transparency reduces uncertainty and inhibits corruption in procurement by assuring equality of access to information for all bidders before, during, and after the bidding process.

Protecting the Interest of Citizens

Whether or not the responsibility for service policy is separated from that for service delivery (Chapter 6), governments have a responsibility of assuring that the services reach the citizens, reaffirmed in judicial decisions in many countries. This responsibility implies setting up recourse mechanisms in case of contractor failure, carefully monitoring contract execution by private suppliers, giving credible information to citizens about the actual providers of service, and opening avenues of complaint.

Environmental Protection

The United Nations (UN) advocates making the preservation of environmental quality and the reduction of waste a part of procurement guidelines.³ Governments could review the purchasing policies of their agencies and departments to improve, where possible, the environmental impact of government procurement policies, including those related to packaging and recycling. In a policy of environmentally conscious procurement, apart from other requirements, the choice of products and production methods is based on criteria of environmental protection and conservation of nonrenewable natural resources; and no specifications discriminate against the use of recycled materials.

LEGAL AND REGULATORY FRAMEWORK FOR PROCUREMENT

Public Procurement and the Law⁴

The legal framework for public procurement includes international obligations, specific domestic legislation on procurement, contract and commercial law in general, and patent and copyright law, labor law, and laws governing lease- and hire-purchase agreements, arbitration, and

conciliation. Some countries (e.g., South Africa) have constitutional provisions as well as enabling laws for procurement (Box 9.2). Others (e.g., the Republic of Korea and US) have passed regulations and legislation. In the US, procurement-related laws include the Competition for Contracting Act of 1984 and the Federal Acquisition Streamlining Act of 1994. The Republic of Korea in 1990 passed the Act Relating to Contracts to which the State is a Party (ARCSP) and the regulations to enforce it.

Box 9.2

South African Constitution and Procurement

South Africa is among the developing countries whose constitution contains a special provision on government procurement. Section 187 of its 1994 Constitution provides the following.

- The procurement of goods and services for any level of government shall be regulated by an act of Parliament and provincial laws, which shall provide for the appointment of independent and impartial tender boards to deal with such procurement.
- The tendering system shall be fair, public, and competitive, and the tender boards shall have to justify their decisions at the request of interested parties.
- No organ of state or any member of state or any other person shall improperly interfere with the decisions and operations of the tender boards.
- All decisions of the tender boards shall be recorded.

Public Procurement Reform in South Africa

Procurement reform in South Africa is part of the extremely difficult challenge of balancing short-term efficiency with the imperative of gradually redressing the racial discrimination of the apartheid regime. South Africa gained nine provinces after the 1994 election, but the Government was hampered by a procurement system that was fragmented, hard to use, and biased toward large, established businesses. The fragmented and onerous procedure often caused delays in delivering services and prevented the government from taking advantage of its size to negotiate in procurement contracts. All contracts had to be approved by 10 Tender Boards (one national and nine provincial), and there were separate boards or committees for parastatal and local authorities. Each of these boards was autonomous, with its own procedures, requirements, and policy interpretations.

continued on next page

Box 9.2 (cont'd.)

The procurement system clearly did not meet the requirements of the Constitution, which stated that procurement must be “fair, equitable, transparent, competitive and cost-effective.” Public sector procurement reform in South Africa is therefore aimed at three main objectives: good governance, uniformity, and achieving socioeconomic goals. An important aspect of the planned socioeconomic transformation, balanced with the objective of efficiency, is encouraging broader participation and overcoming discrimination. The Preferential Procurement Policy Framework Act 2000 is a key piece of legislation in this delicate process. The act specifies a two-tier preference system. For contracts below a certain threshold value, 80 points are rewarded for price and 20 points are allocated to empowerment and development objectives. For projects above the threshold, the split is 90/10. The aim is to enable smaller contractors to bid for lower-value contracts, and to allow some redress for past discrimination. The act will apply to all organs of government (not including the public enterprises), although the Minister of Finance may approve exemptions. A penalty clause is included to discourage established firms from establishing front companies to qualify for preference.

This South African legislation is well worth considering by other multi-ethnic countries that must reconcile short-term efficiency with long-term sustainability and equity.

Source: Laura Walker. Personal communication. 2000.

The Regulatory Framework

Most countries that rely on *general contract law* regulate public procurement by internal rules that prescribe the formal process of bidding, the evaluation of bids, the award and conclusion of contracts, and contract management (Box 9.3). The rules also mandate procedures for dealing with possible court challenges from unsuccessful bidders, and procedures for contract interpretation, breach of contract, and dispute resolution and arbitration. The intention is to provide a self-contained regime for contract award and management, which would avoid recourse to external arbitrators.

The procurement regulations and audit rules place great reliance on competition and objective decision making (except in specified emergencies such as natural disasters). This approach often results in extensive regulatory control and oversight by external agencies, and heavy bureaucratic review and approval processes. Many government entities feel that the procurement

Box 9.3 Procurement Guidelines in the United Kingdom

In the United Kingdom, the Procurement Practice and Development team is the central unit in the Treasury that promotes best practices and the development of procurement strategies by departments. The Government has stipulated the following key points for its senior management: value for money; compliance with national and international legal obligations; cost-effective fulfillment of users' needs; appropriate level of competition; and honest and impartial relationships with suppliers. The procurement process would ensure fairness, efficiency, courtesy, and firm dealings; high professional standards; wide and easy access to information on the procurement process and documentation; prompt notification of the outcome of the bidding; efficiency and integrity in contract management; and prompt response to suggestions and complaints.

In selecting bidders, undue emphasis should not be placed on size, and the standards of financial and technical capacity should be proportionate to the contract in question. The criteria for the award should not consist of price alone, but should also consider other factors like whole-life cost, quality, and delivery. Whole-life cost is relevant in complex procurements, including large supply and service contracts and construction projects, and in offsetting higher expenditure for better quality against the lower maintenance costs over the asset's life.

New Zealand has published *Government Purchasing: A Guide for Suppliers* to help suppliers understand and operate in the government purchasing environment. It is intended to improve communication between public sector buyers and industry to their mutual benefit. Canada provides an integrated electronic public tendering service, which supports open, cost-effective procurement for all levels of government, and all sizes of suppliers in the private sector.

Source: UK Government and World Trade Organization web sites.

process has become an end in itself, stressing compliance with rules to the neglect of economy or efficiency. In 1993, the US had 889 laws that controlled every aspect of defense procurement alone, making a product 50 percent by estimate more costly simply because it was being purchased by the government. Federal regulations filled 1,600 pages, supplemented by 2,900 pages of agency-specific regulations, supplemented in turn by instructions and case law (US Government 1993). Some of these additional regulations are important in public procurement because of its special nature

and risks. In many countries, however, procurement rules would be substantially simplified without compromising the integrity of the process.

After the award of contracts, additional regulations to deal with breach of contract and unsatisfactory contractor performance can be reduced in the first instance through clear and complete specifications, well-defined performance standards, and the inclusion of incentives and penalties in the contract. However, these measures inevitably add costs and delays to the initial phases of contract execution. Formal legal remedies, such as financial penalties or exclusion from future contracts, are costly and dilatory in countries with inadequate judicial systems.

Many countries are consequently moving to streamline and consolidate existing laws and regulations, or writing simpler laws and regulations to govern procurement transactions. In the US, as recommended by the National Performance Review, the Federal Acquisition Streamlining Act of 1994 repealed or modified 225 provisions, and raised the thresholds above which the agencies needed to follow the regulations, thus exempting 95 percent of transactions.

Model Codes

The stress in recent years has also been on a uniform procurement code to set the basic framework for procurement, supplemented by the more detailed rules by implementing ministries. For example, in Australia, the procurement framework is contained in the 93-page *Commonwealth Procurement Guidelines* issued in December 1997. In the UK, the procurement function is exercised under Treasury guidance (Box 9.4). At the subnational level one of the earliest efforts at a uniform procurement code was the *Model Procurement Code for State and Local Governments* in the US. This was the most comprehensive and consistent attempt to apply the elements of good practice, and was meant to be adapted to particular state and local circumstances. The EU insists on enforcing a model procurement code (Box 9.4) as a condition for membership of countries in the Union. The People's Republic of China, for its part, has drafted procurement legislation with Asian Development Bank support.

Box 9.4
Procurement Regulations in Europe

Countries seeking European Union (EU) membership are required to establish and maintain procurement systems that meet standards of transparency and of open and fair competition. Central and eastern European countries have been working to establish modern public procurement systems from the start of their transition to a market economy. Creating such systems is part of the process of forging an efficient, competitive market economy and is necessary for these countries' full integration into the international trading community.

To build and implement the system, significant changes have had to be made from the days of the command economy, when procurement was part of the central planning system. In particular, central and eastern European countries are designing a legal and administrative framework that facilitates the integration of the myriad procurement entities throughout the public sector into a functional and coherent network with high professional standards, and that is consistent with international obligations. Such a framework would define the financial and legal responsibilities of all participants in the procurement process, including suppliers and procurement entities in central and local government.

Slovakia and Latvia have already passed a national procurement law consistent with international standards. Poland has set up a central organization to draft and disseminate procurement regulations and rules for decentralized operation. The Organisation for Economic Co-operation and Development and the International Labour Organisation have collaborated in preparing a public procurement manual for central and eastern Europe.

Source: OECD (1999a).

The most widely used model public procurement law is the one adopted by the UN Commission on International Trade Law (UNCITRAL) in 1994,⁵ consolidating previous model laws. A detailed guide was later issued. The model law was intended to be a model for developing and transitional economies in modernizing their procurement regulations or in establishing such regulations. It is expected to address the inefficiencies and the potential for abuse in the laws of many countries, and to make these laws more compatible with international trade practices. The law has formed the basis for national procurement legislation in many developing countries, with support from international donor agencies. Annex V lists the provisions of the model law. The model law does not supersede

international obligations or the applicable national laws for contract, criminal, and judicial procedures. Although as a framework law the UNCITRAL model law does not itself set forth all the necessary regulations, it mandates open tendering as the method of procurement that is generally most effective in promoting competition, economy, and efficiency in procurement. For circumstances in which tendering is not feasible, the model law suggests alternative methods of procurement.

Manuals and Procedures

Public procurement manuals typically comprise (i) a policy manual, which can include purchasing rules and administrative procedures; (ii) an operations manual of internal practices and procedures; and (iii) a vendor manual, which often takes the form of a booklet entitled *Doing Business with the Government*. Matters of policy (e.g., giving preference to domestic suppliers in international competitive bidding) are generally issued as binding instructions for all ministries and departments, but different countries allow different degrees of departmental discretion in devising procurement regulations. In Singapore, for example, all government entities must follow the administrative procurement procedures laid down by the Ministry of Finance in an instruction manual. On the other hand, New Zealand, the United Kingdom, and other developed countries issue central guidelines but allow individual departments to issue regulations specific to their needs within those guidelines. There are advantages to issuing a single set of procurement guidelines for common guidance, while allowing individual agencies to supplement and vary these according to their needs and those of their clients.

ORGANIZATIONAL ISSUES IN PROCUREMENT⁶

Systematic Neglect

A fundamental problem in public procurement is disinterest and neglect by operational managers, who tend to leave procurement to the “specialists.” There are several reasons for this neglect. Managers are typically more interested in policy, and find the tasks of purchasing dull by comparison. Also, they rarely have enough time to understand the intricacies of product quality, pricing structures, and technical specifications. Moreover, in a climate where the integrity of government operations is coming under increasing scrutiny, keeping some distance from purchasing operations insulates a manager to some degree from potential charges of corruption.

Finally, management distance from procurement decisions is often encouraged by the procurement staff themselves—usually because they view management involvement as interference with little value added, and occasionally for less honorable reasons. A time-honored defensive response to a sudden interest by managers in procurement is to provide them with a large volume of indigestible technical material.

The general disinterest of public managers in procurement matters finds its expression in the absence of the subject from the curriculum of public administration schools. In contrast, business and management schools normally offer one or more courses in purchasing and in contract monitoring.

This is not a healthy state of affairs. In the first place, as noted earlier, the entire field of public administration has its historical origin in the ruler's concern with a malfunctioning procurement system. Second, as stressed throughout this book, the effectiveness of public management depends largely on achieving a good balance between control and flexibility; between protecting systemic equity and providing individual incentives for performance; and between short-term results and long-term continuity. Civil servants have an understandable aversion to risk because of the lack of corresponding rewards and the special external scrutiny to which public service is exposed. Only a climate of trust and higher-level support can prevent such risk aversion from turning into operational paralysis. In the area of procurement, this calls for more involvement by managers and consequently greater support for and control of the actions of the procurement specialists.

Therefore, senior public managers have a central responsibility to become much more involved in the procurement function, especially for large contracts, than is currently the case in most governments. The political leadership can persuade managers to accept this responsibility by making its exercise part of their explicit performance expectations. Of course, senior managers cannot and should not become procurement specialists, but they must be aware of the process and its risks, and there are a variety of ways through which senior public managers can assure themselves of obtaining competent contestable advice. Such an evolution in the public sector would find a parallel in the earlier evolution in the private sector—from product orientation to client orientation—with the result that in the 1970s the separate purchasing activities were merged and entrusted more and more to top levels of management.

Organizational Arrangements

A central question is whether responsibility for procurement should rest with the agency that requires the service or with a central purchasing agency. The main advantage of centralization is that the central procurement officers know the law, policies, and procedures, and have the institutional memory to gain the maximum benefit for government. Decentralization, on the other hand, speeds up the process and places greater emphasis on the services and goods to be delivered. The conflict between central procurement offices and line agencies is typical, and is part and parcel of the general issue of central versus decentralized authority. This conflict draws attention to a number of broader issues that concern not only the executive branch of government but also the legislature and oversight entities such as the audit and anticorruption agencies.

In most countries, the ministries and other spending agencies undertake their own procurement and award contracts for civil works and supplies, subject to procurement guidelines and goals prescribed by a central unit (normally in the ministry of finance). The central unit fixes the threshold for purchases or contracts within the discretion of the head of each spending agency, as well as the procurement threshold for more rigorous tendering under central bidding procedures. In countries where executing agencies are set up for operational functions (Chapter 6), the framework agreement provides for financial autonomy in procurement, subject to certain binding features of national procurement policy.

The following illustrates the variety of practices in different countries. In the UK, a Procurement Policy Team, a joint unit of the Treasury and the Department of Technology and Industry, advises the ministers on procurement policy. In Slovakia, procurement is the responsibility of the Ministry of Construction and Public Works. In Singapore, the Government has decentralized the bulk of its procurement to the ministries, departments, and statutory boards, which make their own arrangements. However, several centralized procurement functions are performed by the Budget Division and the Procurement Policies Unit in the Ministry of Finance, the Construction Industry Development Board, and the Health Ministry (for pharmaceutical products). Australia's federal structure combines central agencies and decentralized departments, as well as central procurement entities with significant support functions (Box 9.5). It is a good example of strategic coherence in procurement. Some countries (e.g., Australia, Canada, and a number of Asian and European countries) have set up specialized

purchase agencies to provide common services and materials for several departments.

It is useful to build a consultation mechanism into the procurement process, not only to give the spending agencies the benefit of expert advice but also to check imprudence in procurement. As an outgrowth of such consultation, purchases by spending agencies may be exempt from the bidding process if they are made from an approved-rate contractor preselected by the central procurement agency. Alternatively, agencies may be required to consult specialized entities or experts when acquiring computer systems and scientific services. Interagency committees may be set up for procuring supplies involving several sectors or agencies. Various other coordination and flexibility mechanisms may be established for effective consultation between the procurement entity and the spending agencies.

Box 9.5
Procurement Organization in Australia

In the commonwealth government, procurement management is substantially decentralized, with each agency responsible for its own procurement within a centrally prescribed framework of procurement policy and advisory guidance on best practices and techniques. The framework also covers government business enterprises. The Department of Administrative Services coordinates purchasing policy and civil purchasing.

Among the entities with procurement responsibilities is Purchasing Australia, which administers the purchasing and disposal framework of the commonwealth government.

Purchasing Australia also supports the general supplier community through the following mechanisms:

- a supplier development program, which assists small to medium enterprises in gaining access to the commonwealth marketplace by linking suppliers with buyers, providing information, and facilitating skills development; and
- The Government Electronic Marketplace Service, which provides information through the Internet about the purchasing policies of the Australian Government and special purchasing opportunities in the Government.

continued on next page

Box 9.5 (cont'd.)

The Office of Government Information and Advertising provides advice and assistance in advertising, market research, public relations, and related matters. It manages the centralized arrangements for commonwealth advertising; disposal of surplus assets; contracting assistance; the facilitation of electronic purchasing; buyer training; and publications and other advisory material on procurement matters.

The Public Works Policy Group (PWPG) assists agencies in applying public works policies. The PWPG promotes the implementation by agencies of best practices in the procurement of construction and related services, and facilitates the ongoing development of best practice strategies.

The National Procurement Board monitors, reviews, and reports on the efficiency and effectiveness of the Government's buying framework and plays a key role in ensuring that all agencies carry out the Government's policies.

Source: World Trade Organization web site: <http://www.wto.org>

WHAT TO DELEGATE AND WHEN

General Issues

As already emphasized in Chapters 5 and 8, the issues of delegation and decentralization pivot around the right balance between efficiency and risk. Typically, line ministries and spending agencies always push for delegating the procurement function, on the grounds that they are the best judge of their own requirements, and can meet them faster and at less cost than going through a central procurement agency. This would be almost always true, except for the problem of the senior managers' disinterest and neglect of the procurement process, discussed earlier. The disinterest of senior managers means that once procurement is delegated to the line agency, it falls under general administration and is no longer given the prudential attention it deserves. The risks correspondingly increase with the delegation of procurement. However, the solution is not to keep all procurement centralized because of the risks. On the contrary, the previous section has pointed to the advantages of decentralized purchasing and contract decisions, subject to central rules, criteria, and oversight. The risks, however, must be addressed—both by encouraging sufficient attention to procurement by senior managers in the line agency, and by retaining robust central oversight.

The key questions to be considered when deciding to decentralize procurement are

- whether it is more effective to develop strict purchasing procedures and contractual safeguards at the center, or to give public managers more discretion to develop procedures and safeguards tailored to the particular goods and services they need;
- how to delegate procurement to the line agencies, while installing appropriate safeguards to prevent abuses;
- the role of the central procurement agency in a context of delegated procurement responsibilities; and
- the degree of corruption and the inefficiency risks of delegation at different stages in the procurement cycle.

The degree of risk varies in different sectors, countries, agencies, and transactions. To achieve a good balance between efficiency and risk one should therefore unbundle the procurement issue. The following considerations may be useful in this context.

Generally, three variables determine the degree of risk:

- specificity;
- market structure; and
- size and complexity of the transaction.

Specificity is inversely related to risk: the more specific the product or contract, the fewer the opportunities for manipulating the procurement process. However, artificial specifications may be included in the standards to favor a particular supplier. Also, other things being equal, greater specificity also entails a smaller market. The market structure in a sector is itself important, with a more restricted and less competitive market associated with greater risk. Next, a large transaction is normally also technically more complex, thus offering greater openings for manipulation and making oversight more difficult. Note also that in the area of procurement the riskiest level of management is middle management, either in terms of inefficiency (through a narrow insistence on the literal application of every extant rule) or in terms of corruption.

To illustrate, information and communication technology is an especially sensitive area. It normally entails the bulk purchase of expensive equipment; requires a level of buyer expertise that is not normally found in

government; and is frequently supply- or donor-driven or both, irrespective of the real needs of the users in a particular country. In this and similar sectors, some mechanism is needed to obtain independent technical advice, as well as to assure much greater participation from the very beginning of the purchasing process by the final users of the equipment or the software.

The sequence of delegating procurement is as important as the end point. Government may delegate certain phases in the procurement cycle first, keeping close tabs on their functioning and strong central control on the other phases—progressively delegating more and more procurement phases as experience permits and performance warrants. Or, delegation may begin first in the less risky sectors or agencies, and gradually be expanded to other sectors. The main phases of procurement (as explained in the next section) are the setting of standards and criteria, the bidding process and evaluation, contract negotiations, and contract monitoring.

A simple scheme may help categorize the degree of risk (which will of course differ according to the specific circumstances of the country), and hence help in deciding which procurement phase to delegate, and for which sector. In the hypothetical illustration below, where the risk of delegating a specific stage of procurement is measured on a scale of 1 to 10 (10 being highest risk) and the risk potential of sectors is assessed on the three determinants discussed earlier (specificity, market structure, and size and complexity of transactions), procurement can be fully delegated in sector V, and not at all in sector Z, while strong central control should be kept in the monitoring phase for sector W, in the standard-setting phase for sector X, and in both the bid evaluation and negotiations phases for sector Y.

Risk Matrix for Delegating Procurement Functions

Sector	Phase of Procurement			
	Criteria/ Standards	Bidding/ Evaluation	Negotiations	Monitoring
V	1	1	2	2
W	3	3	3	9
X	9	2	2	2
Y	2	8	7	1
Z	8	8	8	9

Local Government Procurement and Intergovernmental Aspects

Procurement is becoming important at the local level, in parallel with decentralization (Chapter 5) and the increasing range of functions performed by local governments in most countries. However, legal restrictions on procurement apply much more at the local level because of conditions attached to grants from the center or because of the mandates by national government in areas such as environment.

Some developed countries (e.g., the UK) have been enforcing compulsory competitive tendering at the local level for years, in the interest of service efficiency and quality. Model procurement codes for state and local governments, developed in countries such as the US, envisage a procurement policy unit reporting to the city manager or the district or county commissioner. The unit has no operational responsibility for procurement, but provides research support, maintains a contractor database, and monitors complaints. This could be a suitable system for cities in developing countries, with limited staff and skills.

As noted earlier, there is substantial agreement on the need to integrate centralized procurement policy with decentralized measurement operations. In developing countries, with their scarce skills at local levels, and the greater scope for imprudent and discretionary expenditure, such delegation has to proceed carefully. The higher levels of government must be cognizant of the risk of corruption and waste in local government procurement, and take steps to build local capacities, along with nonintrusive oversight mechanisms. Of course, in countries where corruption in the central government is pervasive, decentralized procurement is likely to improve matters even without special safeguards or technical assistance.

Once the authority is delegated, the higher government level should have the power to monitor and conduct audits, but should not intervene in the award or administration of any specific contract. To address the problem of limited capacities in local units, the state or provincial government could encourage joint procurement, or the award of contracts covering a number of jurisdictions, as is done in France. Also, the provincial government could have the important function of removing barriers to entry for small contractors in local jurisdictions, organizing training programs for contractors and construction firms, and providing support services. Some countries have set up public sector consultant organizations, staffed by experts, to assist local governments in planning and managing large construction and

irrigation works, and in procuring supplies and services from domestic and foreign sources. Finally, the subnational units could take advantage of central rate contracts with reputable suppliers (as in India).

Although not subject to the same rules and constraints, a good deal of procuring takes place *between* levels of government. This partly takes care of the problem faced by agencies in the audit and oversight of contracts with private parties. In addition, contracting with another state agency may ensure for smaller local units a more uniform level of assured services than contracting with private entities. It is important, however, to avoid making local government a captive consumer of higher government series, and therefore the choice of whether to purchase from higher-level government or from private suppliers must be left entirely to the local government concerned (subject only to the general procurement regulations).

THE PROCUREMENT PROCESS⁷

Forms and Stages of Procurement

The forms of procurement practiced in different countries depend mainly on the nature of the goods and services, the size and complexity of the contract, the administrative level, and the market structure. International organization guidelines and bid documents recognize the following forms of procurement, although special procurement procedures may also apply in certain cases:⁸

- competitive bidding (international or national),
- shopping (international or national),
- direct contracting (sometimes called sole-source contracting or direct selection),
- force account, or
- procurement through agents.

Competitive bidding (also known as open tendering) is aimed at providing all eligible bidders with timely and adequate notification of the requirements of the procuring agency and an equal opportunity to bid for the required goods, services, or works. Some countries may give preference to domestic suppliers, as noted earlier. National competitive bidding is normally used when foreign bidders are unlikely to be interested because of the nature of the goods and services or the purchase is of a small size.

Otherwise, international competitive bidding is used. Limited competitive bidding without public advertisement is indicated when the values are small or when there are only a few suppliers. Bids are sought from a limited number of potential suppliers, but broad enough to assure competitive prices. Many local governments float such limited tenders for repetitive purchases, including engineering items and construction materials, on an annual basis and place repeat orders with one or more contractors.

Shopping involves comparing price quotations obtained from at least three suppliers for readily available off-the-shelf goods of small value, such as office equipment, furniture, medicines, books and educational materials, information and communication materials, and similar small supplies. World Bank projects in India, for example, permit shopping procedures for items estimated to cost less than the equivalent of \$30,000 per contract, up to a specified maximum amount.

Force account, or direct government supply and public works, is the provision by the government's own personnel and with its own equipment. It is justified where the works are small or scattered, the amount of work cannot be specified in advance, or in emergencies. In all other cases, procurement by force accounts has tended to be less economical owing to the lack of any competition for the services.

Where the buying agency lacks the necessary organization or skills, it may employ as its agent a specialized procurement spending firm, or a project management firm for construction contracts. Consultants are also often used to draw up documents or to inspect supplies and works.

Direct selection, or sole-source selection, is used for relatively small contracts requiring the specialized skills of a specific individual or firm, and in situations where time is of the essence.

The different forms of procurement are applied to contracts of different value, with the simplest forms being used for lower-value purchases. For example, the World Bank normally requires international competitive bidding for purchases worth more than US\$200,000; permits national competitive bidding for purchases between US\$30,000 and US\$200,000; and permits shopping and direct selection for purchases of less than US\$30,000 (or vehicles costing less than US\$100,000).

In various forms of build-operate-transfer contracts or under turnkey projects for construction, the private company is allowed to procure the goods and services for the project, in accordance with designs and specifications agreed in the contract. Conversely, government agencies in developing countries sometimes handle international bidding and related services for small firms.

Competitive Bidding

Stages of the process

As noted, competitive bidding is prescribed for procurements above a specified value threshold set by the ministry of finance or the central procurement agency. Besides private suppliers, potential bidders include city and county departments (for local services), nonministerial public bodies, and nonprofit organizations.

The complexity of the process depends on the value and nature of the goods or services being procured, but the requirements for competitive bidding are similar in all cases and largely applicable to other forms of procurement as well (Transparency International 1996):

- a clear and fair description of what is to be purchased;
- a publicized opportunity to bid;
- fair criteria for selection and decision making;
- the receipt of bids from responsible suppliers (or contractors);
- comparison of bids and determination of the best or most responsive bid, according to the predetermined and publicized rules for selection; and
- contract award.

Accordingly, the stages in the process of competitive bidding are

- prebid,
- public notice and invitation of bids,
- bid opening and evaluation,
- resolution of complaints, and
- contract award and conclusion.

Prebid process

Prebid requirements include standardized bid and tender documents, rules for classifying and registering contractors and suppliers, rules for prequalification, bid evaluation committees (if necessary), and process of deciding on the award of bids. The documents must contain clear specifications, instructions to bidders, and contracting terms. The key requirement of a fair and open process is the easy availability of bid documents in comprehensible language to all willing bidders. A number of countries make the information and documents available in electronic form through convenient outlets or through associations of contractors.⁹

Enough time must be allowed for potential suppliers to bid, for the purchasing agency to evaluate the bids and make the award decision, for the final details of the contract to be negotiated, and for the goods and services to be received or the work to begin. Procurement planning must take these time requirements into account, and the purchasing agency needs to begin the process early enough to ensure that the goods and services will be ready when needed, and avoid having to make high-cost decisions. Recall that timeliness of purchase is one part of the economy criterion.

The bidding process in many developing countries is often impaired by unclear specifications because of a deliberate intent to leave room for discretion or imprecise thinking at the agency level. Contractors and suppliers need clear specifications to respond competitively to the requirements of the purchaser. The specifications should be substantive and permit the acceptance of offers of generic goods that substantially provide the performance specified. Services must be clearly specified in terms of their outcomes or outputs, not only their inputs, but without dictating exactly how the activity is to be performed. Sometimes the specifications and required qualifications are so detailed as to apply to only one or two potential bidders. This is almost invariably done to circumvent the requirements of competitive bidding and in effect operate by direct selection, for good or bad reasons.

Participation of small contractors is often facilitated by dividing the service area into a number of smaller regions or a number of similar packages of equipment and works (a form of unbundling), and encouraging competitive bidding for each area or package. There is less risk of disruption of supply or services in this process of unbundling, but the downside is the likely higher cost of overall procurement and the bias of central governments in favor of large tenders.

Public notice and invitation to bid

Timely notification of bidding opportunities is essential in competitive bidding. The notice should be published in local and national newspapers, official gazettes, or electronic bulletins, to suit the nature and size of the project. Information on the invitation to bid should be available in offices of the agency, and the district or county administration for local projects. Bid notices should be publicized in the local language where small contractors and community organizations may be likely to bid. International bids should be published in widely circulated trade journals and newspapers, and through the Internet.¹⁰

In the case of large, complex works, turnkey contracts, or large consultancies, a two-stage bidding procedure may be used. Unpriced technical proposals are first invited based on technical and performance specifications. Bidders whose proposals are judged to be responsive to the technical criteria are then invited to submit price bids.

Prequalification of bidders is usually necessary for large or complex works or in cases where the high cost of preparing bids may discourage competition, such as for custom-designed equipment, industrial plants, specialized services, turnkey contracts, or management contracts. The process ensures that invitations to bid are extended only to those with adequate capability and resources. Prequalification is also used to determine eligibility for preference for domestic contractors in donor-assisted projects. Prequalification should be restricted to the capacity, experience, and resources of the contractors to perform the particular contract satisfactorily, taking into account their past performance in similar contracts. As always, prequalification must be based on transparent and well-publicized guidelines.

Specified criteria are used in deciding which persons or entities are allowed to bid. Sometimes contractors are prequalified for a group or type of contracts over a period of time. In case of projects financed by donor agencies like the Asian Development Bank (ADB) and the World Bank, as well as some governments, prequalification also serves as a check on the integrity record of the contractor, by stipulating that the bidder shall not be under a declaration of ineligibility for corrupt and fraudulent practice. This practice is increasingly required, in parallel with the recent emphasis on fighting corruption in developing countries (Chapter 17).

The guidelines of ADB and the World Bank provide that, as far as possible, the bid package or contract is of such size as to attract competition. Where a number of separate but similar works or items of equipment are to be procured, bids may be invited under alternative contract options from large and small contractors so that the contracts can be evaluated separately or together, or sliced and packaged to secure the most advantageous terms.

The *bidding documents* should furnish all the information necessary for a prospective bidder to bid for the goods, services, or works to be provided. While the detail and complexity may vary with the size and nature of the proposed procurement package, the bidding documents generally comprise the following:

- invitation to bid;
- instructions to bidders, including the criteria for bid evaluation;
- form of bid;
- form of contract;
- general and special conditions of contract;
- specifications (and drawings where relevant);
- list of goods or quantities;
- delivery time or schedule of completion; and
- necessary appendixes for such items as the types of deposits or securities.

The documents should be both in the local language and in an international language (normally English).¹¹ To assist developing country governments, international organizations have prepared standard bidding documents for different types of procurement. In many cases, the aid-receiving government is required to use the standard bidding documents of the donor organization. This practice may appear to be intrusive, but it saves resources and provides needed protection for both the donor and the recipient, and boosts the confidence of suppliers.

Bid opening and evaluation

Key to transparency and fairness is to open the bids at a designated time and place in the presence of all bidders or their representatives who wish to attend. Such public bid openings reduce the risk that bids will be leaked to competitors, lost, or manipulated. After the bids are opened, no information on the bid evaluation and award recommendations should be disclosed until after the successful bidder is notified of the award.

Bid evaluation is one of the most difficult steps to carry out correctly and fairly in the procurement process, and one of the easiest steps to manipulate. Most countries provide for bid evaluation committees for procurement above a threshold value. Experts are called in to assist in evaluating complex bids. Decisions on bids of small value are delegated to the appropriate lower level. A report on the evaluation of bids should be prepared, giving the specific reasons for the recommendations. This process also calls for the exercise of judgment in spotting unrealistically low bids, which will lead to change orders during a project or to unsatisfactory performance. Management in developing countries especially has to be on guard against rigging of the process by a group of suppliers or contractors willing to share the market or rotate jobs. It is important for the results of the bidding process *as a whole* to be evaluated periodically to identify suspicious trends.

Unusual or lengthy delays in bid evaluation are often a sign of trouble, an indication that someone in the system is attempting to discourage the best bidders or give extra time to favored bidders on the basis of leaked information. Such delays should be strongly discouraged.

Award of contract

The agency should award the contract within the period of validity of the bids to the bidder whose bid has been determined (i) to be substantially responsive to the bidding documents and (ii) to offer the lowest evaluated cost. The bidder should not be required to undertake responsibilities not stipulated in the bidding documents or to otherwise modify the bid. However, if the winning bid exceeds the prebid estimates, the agency may negotiate with the successful bidder to lower the contract price by reducing the scope of work or reallocating responsibility. This process should be transparent and according to objective criteria. There, too, delays are often a symptom of unfair or corrupt practices.

EU requires purchasing agencies to make the results known by means of a contract award notice published in the official journal and the data bank of the EU. The notice should specify the conditions under which the contract was awarded (i.e., the criteria applied and the price). EU also requires agencies to give the reasons for selecting the successful bid to the unsuccessful bidders, and entitles the latter to ask for review based on the claim that proper evaluation procedures were not followed. While many countries follow the practice of making information on the award of contracts

available to the public, there are no uniform practices for informing the unsuccessful bidders.

Rejecting all bids is justified where there is lack of effective competition or none of the bids is substantially responsive. If it rejects all bids, the agency should consider wider advertising, after examining the reasons for the lack of responsive bids or the low number of bidders, and possibly make suitable revisions in the bid documents. Note, however, that rejecting of all bids is sometimes an indication that improper negotiations are being conducted on the side. Similar to undue delays in evaluating bids, rejecting bids may be a device to elicit bribes from contractors, or provide privileged information to “friendly” contractors who can subsequently place an artificially low bid.

Redress of complaints

Avenues should be available for entertaining legitimate grievances and complaints from bidders about the fairness and confidentiality of the process, and for furnishing clarifications. Most countries provide for procedures within the procurement entity itself for investigating complaints from contractors and their redress or disposition. In Japan, a special unit in the cabinet office considers complaints relating to international competitive bidding. In some countries, complaints can be addressed to the ombudsman if the purchasing agency is unresponsive. Some countries provide for a review of the decision on the award of the bid if representations are received from the other bidders in time, but all procurement decisions are open to judicial challenge in most countries. Attitude is also important. The unresponsive behavior of procurement staff to complaints and suggestions can make it less attractive to do business with the government, and thus reduce effective competition in the future. This, of course, may sometimes be precisely the goal of the unresponsive behavior of procurement staff.

EU requires the establishment of complaint procedures, which allow the bidding firms to challenge decisions taken during the procurement process, either in general courts or in courts with standing jurisdiction over public procurement, or (as in central and eastern Europe) by administrative commissions empowered to intervene. Hungary and Poland have created specialized institutions to deal with public procurement complaints, inspired by the model UNCITRAL law.

Other Forms of Procurement

Sole-source procurement

Sole-source procurement is also called single-tender purchase, direct selection or direct contracting. It is manifestly appropriate for the purchase of highly specialized systems and equipment, in cases of emergency or natural disasters, or when the standardization of equipment or spare parts (and reasonable prices) justifies additional purchases from the same supplier. In some developing countries, competitive bidding is waived if the procuring entity directly entrusts the supply or works contract to a state-owned enterprise on a negotiated basis. Sole-source purchases account for more than 50 percent of federal purchases in the US, mostly for certain specialized equipment or supplies (as in the aerospace and defense industries), where only one firm is technically qualified to provide the goods, services, or works.

Direct selection is also appropriate and cost-effective in the procurement of consulting services, when a track record of specialized technical expertise is essential and timing is important. This is often the case for public sector management services, when contracts are comparatively small and individual consultants are required.

Direct selection is defensible in developing countries if there are rules for how and when this form of procurement is used and the determination is based on some form of market research and product testing. Otherwise, it could become a cover-up for collusive corruption or bureaucratic laziness in exploring better alternatives. Care must be exercised especially in evaluating the bids in spot purchases of commodities like crude petroleum and armaments, as these have been the subject of scandals in many countries.

Requests for proposals

Requests for proposals (RFPs) are negotiated bids, wherein the parties enter into a contract after discussing its terms, provisions, costs, and other elements. There is no formal bidding. RFPs are most common in consulting or other personal professional services, such as those of architects. Unlike the invitation to bid, which focuses on minimum qualification, RFPs focus on quality. RFPs are also used for sole-source suppliers of special products such as computer software programs or special patents (as for experimental programs like a new process of sewage disposal).

The RFP process starts with defining the scope of services and proceeds to identifying the possible bidders, who are then encouraged to make an offer to provide the service or product. The price and other terms are then negotiated. In developing countries, RFPs create an impression of corruption as they are inherently judgmental, often not transparent, and may lead to higher costs. The combination of technical judgment and negotiation calls for agency skills that are in short supply in many countries, possibly leading them to depend on the judgment of foreign consultants. Since many developing countries use RFPs for projects, this procedure needs carefully worded and transparent policy guidelines and procedural regulations, and personnel skills to manage the process.

Procurement from other government entities

Intergovernmental contracting is a service delivery choice in which one government unit agrees to provide a service to another government unit (Rehfuß 1989). A simple example of such a contract is one where a county agrees to collect refuse for a city—a service for which it would normally bill the citizens directly. The county may receive payment from the city or use property tax levies to defray the costs. These quasi-contractual arrangements could be informal.

Joint service agreements, such as those in countries following the French tradition, are formal agreements between local government units (and sometimes state agencies) for joint planning, financing, and delivery of services (such as water supply or data processing) to the inhabitants in the participating jurisdictions. These agreements generally entail formal service contracts (such as for the maintenance of streets and sewage plants) approved by the legislature or the government and legally enforceable. A newly incorporated city could compare the cost of providing all services through its own employees, with the cost of having them provided by another city, and make a rational choice between self-provision and joint services.

Intergovernmental contracting is also a useful means of governmental integration in developing countries. It can ensure uniformity of services and economies of scale, avoid many of the hassles of contract management, and, more importantly, create a habit of cooperation among local government units, or what we may call governmental social capital.

Small purchases

Virtually all countries and international organizations have established a value threshold below which competitive bidding is not required and procurement is delegated to lower levels of authority or shopping procedures are permitted (India and Singapore are Asian examples; also refer to the World Bank practice noted earlier). The procuring entity is allowed to award the contract based on a simple evaluation of at least three quotations obtained from a number of known suppliers. The contract agreement is simple and often consists of a mere exchange of letters. Some countries permit the registration of authorized vendors and the placing of orders with them by rotation during the year. Many countries have made provisions for contracts to be awarded, at a negotiated price, to labor and community associations, after ascertaining their competence and experience.

In developing countries, poor-quality goods are often bought at exorbitant prices through collusion, using the procedure of purchase through quotations, as the Presidential Commission in Tanzania (Box 9.6), for example, has found. This is sometimes the reason behind the practice of splitting annual purchase requirements into several small packages below the threshold level. However, the practice may also be due to fluctuations in the availability of funds for agencies during the year, and the considerable delay from central purchasing. Splitting up a large purchase may be the only way for an agency to get around the inefficiencies of central purchasing offices. Still, since small purchases can add up to a significant part of the budget, the scope for corruption and waste can be substantial. The main safeguards are alert public managers and robust audits of such small purchases on a sample basis. When the splitting-up practice is forced on public managers by inefficient central procurement or overly complex rules, however, the solution is not to prevent the practice but to reform the central procurement entity or streamline the procurement rules.

Box 9.6
Government Procurement in Tanzania

The report of the Presidential Commission against Corruption in Tanzania has described and illustrated the nature of corruption in construction tenders and procurement. It noticed a total disregard for rules and regulations. There were huge differences between the tendered cost and the final cost of completion. The commission felt that these contracts were being used to defraud the Government.

Government procurement procedures revealed several deficiencies, allowing loopholes for corruption and large financial misappropriations to develop. Corruption in procurement from the central government stores was because of poor leadership, scarcity of essential commodities due to poor recordkeeping, a lengthy bureaucratic process of collecting goods, and poor procurement systems. Purchase through price quotations, which was to be used only during emergencies, had become the normal procurement procedure. Poor-quality goods had been procured at exorbitant prices through collusion and without the approval of the relevant authority. The procurement of nonexistent goods through the use of proforma invoices had become widespread because of this procedure. Financial orders were not updated and were deficient in laying out procedures for construction tenders. The personnel who handled costing and evaluated tenders did not check current market prices in evaluation. Some bidders bribed their way into the preparation of favorable bid specifications and prequalification. The procurement officers sometimes advised the bidders to quote a low price, and then assisted them with change orders to enable them to receive higher payment. Bids awarded in violation of procedures were nonetheless often ratified by higher authorities.

Source: Tanzania (1996).

Procurement from nonprofit and community agencies

Local communities or nongovernment organizations (NGOs) are encouraged to participate in contracts in a number of countries, and even in projects assisted by donor agencies. The objective could be to promote project sustainability, achieve specific social objectives, develop local “ownership” of a project, meet user requirements more precisely, or reduce transaction costs. The approach is particularly relevant to the delivery of social services to targeted groups. The nature of community-based procurement will depend on local circumstances and could vary even within the same country. Despite the many advantages of NGO participation in government procurement, there are also risks and pitfalls, and developing

countries need to exercise caution. These issues are discussed at length in Chapter 15.

In many countries, affirmative action policies dictate set-asides for small business, minority business, or women-owned business. These transactions are not always meant to be market-based because they attempt to correct perceived market imperfections or introduce social purposes into economic outcomes.

Bidding in Projects Financed by Donor Agencies¹²

Because of the importance of public procurement in the management of public expenditure and the proper use of external aid, multilateral organizations such as the UN, ADB, World Bank, and EU have issued guidelines for procurement in projects they finance. Most bilateral donor agencies have also issued procurement guidelines, but their practices vary. Several still insist on tying aid to the purchase of all goods and services that are not locally available, including consulting services, to suppliers in the donors' own country, despite the well-known distortions and inefficiencies caused by tied aid.¹³ Some donors insist that international competitive bidding be limited to countries within the region. Others require contract clauses relating to social purposes such as the prohibition of child labor. Preference for domestic suppliers is not always included. However, all donors insist on integrity provisions similar to those of the ADB and the World Bank.

The World Bank, ADB, and the other regional development banks recognize that the responsibility for implementing a project rests with the borrower and that the mode of procurement for the project depends on the circumstances and policies in the aid-recipient country. However, they generally insist on the use of standard bidding documents.

Four considerations generally guide the requirements of aid organizations (World Bank 1995):

- economy and efficiency in implementing the project;
- opportunity for all eligible bidders from developed and developing countries to compete for the right to provide goods and works financed by the organization;
- promotion of domestic contracting and manufacturing industries in the aid-receiving country; and
- transparency in the procurement process.

Independently, both the World Bank and ADB have been assisting member countries in incorporating the best principles of procurement in new or amended regulations, and in devising procurement procedures and tender documents that meet the requirements of international conventions. A similar objective has guided the efforts of the Organisation for Economic Co-operation and Development (OECD) to assist the countries of central and eastern Europe in reforming their procurement regulations and practices.

Recently, ADB and the World Bank have issued guidelines on fraud and corruption to require borrowers, as well as contractors, to observe the highest standards of ethics in the procurement and execution of contracts. Some credits have been canceled and a number of contractors and suppliers have been sanctioned—some who were found to have engaged in corrupt practices were barred for long periods (Chapter 17).

CONTRACT ADMINISTRATION AND MONITORING¹⁴

Importance of Contract Administration

Contract administration and monitoring is a neglected area in many developing countries, reflecting poor implementation capability in government in general. Contracts must be carefully implemented and monitored. Resorting to contracts with private parties does not solve the problems of bureaucracy. Indeed, accountability may become more difficult because at least three organizations are involved: the public organization that completed the bidding process and awarded the contract, the public agency that is expected to oversee the execution of the contract, and the private entity that will execute the contract. Developing countries are rife with examples not only of outrageous delays and excessive costs of implementation, but also of abuse, waste, and fraud in contract execution. Contracting out services, supplies, or works does not relieve the government of responsibility for the manner in which the service is provided or the work constructed, and for the quality of both. Any government that forgets this rule will be very sharply reminded by an angry public as soon as something goes wrong.

The effectiveness of contract management is strongly influenced by decisions made prior to the award of contract. Ambiguous, unrealistic, or conflicting agreements make it very difficult for the public manager to oversee their execution. Contract size also plays a part in determining the scope of contract administration, but the skills of coordination and

negotiation, and in-depth knowledge of contract terms and customer expectations are important in all cases.

Many contracts do not have clear performance standards, which permit the contractor's work to be judged and also protect contractors from arbitrary interference. Procurement managers need to be encouraged to draft contracts that emphasize results, make monitoring feasible, and are easily understandable to field officers and contractor representatives alike.

It is important to note that while the government operates all over the country its procurement for large contracts is concentrated at the center. Consequently, the field administrative units responsible for supervising contract execution often have no idea of the basis for the award of the contract, but nevertheless have to subject themselves to inspection by the oversight agencies.

Nature of Contract Monitoring

Contract monitoring

Monitoring continues through the life of the contract. No amount of careful preparation of the contract or detailed specifications will ensure adequate performance if the actual performance is not monitored. Monitoring contract execution includes reviewing contractor reports, making inspections, commissioning audits, and obtaining citizen feedback. The relationship between the public official and the contractor should not be adversarial and antagonistic. Nevertheless, direct inspection and observation of the progress of the work remains the most important element. Financial audits, while necessary and usually required, come too late to remedy problems of execution, though they can provide evidence of wrongdoing, which can be used to fight a court case or disqualify the contractor from future work. In contrast, experience suggests that detailed reviews by higher officials often take up too much time and effort without significant results. On the positive side, establishing good and professional relations with the contractor can do much to assure good contract execution.

Often, corruption is permitted by the filing of unrealistically low bids, in the tacit agreement that the contract assessment will be increased after contract negotiations due to unforeseen circumstances. Only strong contract monitoring can prevent these practices.

Quality assurance

Quality is a component of economy and quality assurance is a critical aspect of contract monitoring. It relates critically to the clear drafting of the technical and other characteristics of the product, work, or service to be provided under the contract. The nature of the quality assurance task will depend on the nature of the output. Inspectors of construction work, for example, demand compliance with building codes and similar legal mandates in addition to compliance with the purchaser's specifications. Many countries have established quality control units in their public works ministries.

Some developed countries have established the policy of making the contractor responsible for verifying and assuring product quality prior to delivery. However, this policy requires a high degree of contractor responsibility, contract management skill, and swift dispute resolution. All three factors may be deficient in many developing countries. Accordingly, governments in developing countries should be especially careful about relying on physical output performance indicators as this could lead to a lower-quality output (Chapter 18 for a full discussion).

The central procurement office should disseminate guidelines for the inspection and testing of goods and services under different types of contracts, including information on the available testing facilities and on other quality assurance techniques (such as a requirement to obtain certificates of compliance or certified test results to accompany deliveries). There should be a formal system for reporting complaints against vendors by user agencies and the public, for taking action on deficiencies noted during inspection, and for dealing with product warranties and latent defects in goods. The payment schedule should be tied to inspections so that payments can be withheld when problems occur and until they are resolved satisfactorily. Citizen associations should be systematically consulted, not only because of their involvement as stakeholders, but also because feedback from informed citizens is a highly reliable and cost-effective way of monitoring contracts and ensuring the integrity of public officials.

MILITARY PROCUREMENT¹⁵

Military procurement differs from civilian procurement as it is affected by considerations of national security and conducted in a less transparent manner than other forms of procurement. Equally important is the bilateral

monopoly structure of the market for military equipment and weapons on both the supply and the demand side in the US and some European countries, and the consequent political sensitivity of this area of procurement. On the supply side, the enormous fixed costs and scale economies involved in the production of costly defense equipment, and the need for high research and development (R&D) investment in new technology, raise barriers to entry for new companies and establish different principles for recovering costs from the contract. On the demand side, the government exercises monopsony control as single buyer of the equipment and spares produced by the defense industry.

As noted in Chapter 1, despite its decline in the past decade, military expenditure is still huge, amounting to almost US\$500 billion worldwide in 1998, or US\$130 per year per person. Military expenditure must be considered together with the turnover of arms-producing companies in order to comprehend the magnitude of military procurement. The top 100 arms-producing companies had combined arms sales of US\$156 billion in 1997, with the US, France, Russia, and Germany as the major producers.

The officially reported military expenditures in developing countries do not reveal the much higher actual expenditure. Defense allocation is not often disaggregated, and is shown as a single line item in the budget. The additional income from arms exports and the earnings from the business activities of the army are not shown on the revenue side. Off-budget items, such as expenditure on paramilitary forces, food subsidies to army personnel, military research and development, and subsidies for arms production and imports, are often not shown at all. Secrecy in security matters leads to the omission of provisions made for major equipment purchases. All this makes it difficult for oversight agencies to exercise audit and vigilance.

Military expenditure goes to staff emoluments and pensions, various forms of civilian supplies and amenities, and military equipment and supplies. In the US, 60 percent of the amount spent on depot-level weapons systems and maintenance supplies in 1995 was acquired under contract (Jones 1999). Regional agreements, such as those of the EU, seek to eliminate local preferences in the public purchase of civilian goods but exempt military equipment.

It is usually difficult for the ministries of finance in developing countries to regulate expenditure on defense procurement and the use of scarce foreign exchange because of overriding political perceptions of threats

to national security, internal solidarity, and the sensitivity and secrecy surrounding the purchase of major equipment. The requirement for the emergency purchase of equipment and supplies and the superior bargaining advantage of foreign suppliers in many cases, circumscribe the capacity of purchasing departments and the treasury in striking financially favorable deals.

A distinction has to be drawn between sophisticated equipment with a specific defense use and commercial off-the-shelf defense supplies, including items for both civilian and defense use. In the case of purchases of foodstuff, transport, and civilian supplies, the defense establishment can easily apply the principles of procurement discussed above. But even here, of course, there are stories of grotesque overpricing, such as US\$5,000 coffeepots and US\$200 pliers, etc. (Gregory 1998). Aside from possible fraud, overpricing usually arises because of excessive specifications even for everyday items in military contracts, and the need for the military contractor to recover the entire sunken cost of production from a few items supplied to the army (as opposed to spreading the cost across millions of items in the production run for civilian sales).

In the case of defense supplies, many countries tend to buy from home suppliers, even at some additional cost. The label military-industrial complex sums up popular perceptions of the nexus between domestic industry and the defense establishment. Military hardware (aerospace equipment, electronics and telecommunications equipment, explosives, shipbuilding equipment, etc.) accounts for the largest share of total equipment expenditure. Defense equipment and R&D contracts can give a competitive advantage to supplying firms in technological, commercial, and financial terms. The Association of Southeast Asian Nations (ASEAN) countries have pursued a policy of preference for local private industries when it comes to defense supplies.

Other countries rely on defense equipment and supplies from public factories to reduce their dependence on foreign suppliers and their vulnerability to arms embargoes. Some form of arms production is undertaken by 41 countries, including Asian countries like People's Republic of China, India, Korea, and Pakistan (Brazoska 1999). Many of them, including Brazil, Israel, Republic of Korea, Singapore, and South Africa, undertake defense exports of varying magnitudes. Production of arms by the public sector helps to avoid the fraud and abuse associated with procurement from private domestic and foreign suppliers. However, such

production usually covers small arms and ammunition, rather than high-technology equipment, and may be much more costly than outright purchases. Some countries in Europe and Asia have sought to achieve a compromise between outright imports and indigenous self-sufficiency in defense by setting up licensed production units with foreign companies.

It is important to note that the risks and costs of defense procurement are markedly different for countries without an advanced defense industry. Where the countries are obliged to secure defense supplies through imports or purchases in overseas markets, the balance of bargaining power is with the suppliers. Aside from force and corruption considerations, there is a risk of purchasing outdated equipment—weapons that do not fire, planes that do not fly, etc. At the same time, self-sufficiency in defense requirements has not been possible or desirable for developing countries. Even countries with defense production units are obliged to shop for sophisticated arms and aircraft from foreign suppliers. Apart from problems of patents and secrecy, the research and development costs of defense equipment and supplies are unaffordable to most developing countries.

Some countries have sought to apply the principles of civil procurement to defense supplies as well, with built-in procedures for confidentiality. There is a specialized defense procurement division in the Singapore Ministry of Defense, and other countries like Canada have set up similar specialized divisions or agencies for defense procurement. The procurement process is subject to oversight by supreme audit agencies in many countries, and the publication of audit reports for the benefit of the legislature and the public.

Many developed countries have prescribed an elaborate process for defense procurement and a protracted approval process through various levels from the contracting officer to the treasury, and then to a cabinet subcommittee. The process is further complicated by detailed requirements and specifications, compelling the industry to prepare costly and voluminous proposals, which are then analyzed in great detail by a large team of evaluators. Much of the waste and delay that has been publicized in the US has been attributed to overregulation, overspecification, excessive paperwork and audit compliance, too many layers of authority and supervision within the executive, and micromanagement by the Defense Department and the Congress (Gregory 1989). Canada devised the Smart Procurement Initiative in consultation with the defense industry to improve the procurement process. It included innovative steps like incremental acquisition, greater

flexibility and delegation for small-value and off-the-shelf items, streamlined decision making, and partnerships with business.

The situation is different for most developing countries that have a poor defense industry and depend on imports, and the question is not just one of making things easier and fairer for the contractors. The problem there is not overregulation and complexity, but the lack of transparent, credible, and consistent systems for defense procurement, inadequate legislative and audit oversight, and the failure to institutionalize decisions relating to the acquisition of costly equipment. In countries with a weak defense industry base and inadequate purchase evaluation capacity, the potential for bribery is mixed with the danger of purchasing inefficient equipment. Where military aid is provided by developed countries with tied purchases from the donor country, the recipient country often has no control over the cost and quality of the equipment and spares, and merely watches as its foreign debt rises with its defense spending. The country that is locked into the use of particular equipment and transport also becomes vulnerable to a supply cutoff in spare parts and replacements by the donor country. Defense procurement thus becomes the handmaiden of the vicissitudes of foreign policy. At the same time, developed countries seeking to procure military supplies in support of their army operations in a friendly country are beset by collusion and cartels (as in the case of the Republic of Korea in the 1960s; see Klitgaard 1998). Efforts to deal with the problem through bilateral bargaining have opened new avenues for corruption.

The military procurement process is permeated by the interplay of international and domestic companies, liaison agents, arms bazaars, contributions to political parties, and bribes, and is punctuated by the outbreak of scandals and media exposés. The best single cover for corruption in international defense procurement is the commission paid to a local agent by the foreign arms manufacturer or supplier. The agent is given sufficient funds to land the contract without the parent company having to know the details, creating a comfortable wall of distance between the supplier and the act of corruption, and enabling all the parties in the recipient government and the parent company to disclaim any association with the unsavory details of the deal, should these be exposed.

Once again, Singapore is one country that has declared and observes a transparent policy for defense procurement based on open tender. The principle is to go for the best source that meets the requirement and gives value for money. The policy is to deal directly with overseas and domestic

suppliers and avoid dealing with intermediary agents in contract negotiations. This is much easier said than done, however, for most developing countries, where accountability and public management are not as strong.

SAFEGUARDING INTEGRITY IN PROCUREMENT¹⁶

Areas of Corruption

The subject of corruption is dealt with in Chapter 17. This section discusses briefly specific aspects of corruption in procurement, which is a major problem in all countries and at all levels of government and administration. This problem is hardly new. Over 2,000 years ago, Kautilya wrote in *Arthashastra*

Just as it is impossible not to taste honey or poison that one may find at the tip of one's tongue, so is it impossible for one dealing with government funds not to taste, at least a little bit, of the king's wealth.

Corruption can occur in procurement mainly if there is excessive regulation; the rules are not clear and accessible to the public; the bid documents are poorly drafted or ambiguous; the specifications and standards are not clear; and contract monitoring is loose. Accordingly, either the procurement unit or the bidder can corrupt the procurement process. The procurement unit can

- tailor the specifications to benefit particular suppliers or contractors;
- restrict information on bidding opportunities to only some potential bidders;
- claim urgency as an excuse to award the contract on a sole-source basis;
- give preferred bidders confidential information on offers from other bidders;
- disqualify potential suppliers through improper prequalification or excessive bidding costs; and
- act directly in collusion with the bidders or outside influences to distort the entire process.

The bidders, too, can take a number of actions to distort the bidding process and its outcome, such as

- colluding among themselves to fix bid prices;
- colluding to establish a rotation or other system by which bidders will not participate by turns or will deliberately submit unacceptable or technically unsuitable offers (even the most careful scrutiny of individual transactions will not reveal this tactic, as mentioned earlier, it is necessary from time to time to review all the procurement results for a given period);
- promoting discriminatory technical standards; and
- using their influence or bribes to push political leaders or senior public officials to interfere improperly in bid evaluation.

However, the most direct approach to bribery is to avoid competitive bidding altogether, and contrive to have the contract awarded to the desired party through direct negotiations without any competition.

After the bids are submitted, other opportunities for misbehavior arise. As noted earlier, confidentiality is critical to the fairness of the exercise. Where the rules do not provide for all bidders to be present at the time the bids are opened, it is easy for the procurement officer to reveal the lowest bid to the desired bidder and enable the latter to submit an even lower bid, which is then included in the bid evaluation process.

Serious corruption problems arise also during the contract execution phase, after the award of contract, through practices such as

- failing to enforce quality standards, quantities, or other performance standards of the contract (it is often understood in advance that enforcement will be superficial or nonexistent);
- paying for shoddy construction, or agreeing to the delivery of unacceptable goods and services, or acceding to fictitious claims of losses in transit or false deductions for material losses in construction;
- permitting “lowballing” (accepting artificially low bids, which are then jacked up by mutual consent, for a price);
- delaying payments to extort a bribe;
- spot purchases of commodities during emergencies; or
- giving individual legislators influence over the award of contracts in their constituencies (the so-called pork barrel).

By far the easiest and most profitable form of corruption in public procurement or works is simply not to deliver the goods or build the works.¹⁷ In countries with weak accountability systems, very low administrative

capacity, or widespread systemic corruption, it is not a difficult matter to falsify delivery documents or certificates of work completion. It is in this area that citizens' feedback can be a powerful weapon against corruption.

Political corruption, either financing of political parties in exchange for contracts or official posts, or cooptation of legislators by giving them influence over the award of contracts in their constituencies, is frequent in many developed and developing countries, but goes beyond the scope of this book. It is clear, however, that illicit political financing or pork-barrel politics are a blight on the integrity, efficiency, and effectiveness of public administration. The remedies, however, are almost entirely political and not technical or administrative. This is a major reason why illicit political financing is excluded in the OECD Anti-Bribery Treaty (Chapter 17).

International Efforts to Secure Integrity in Procurement

International lending agencies like UN, World Bank, and ADB are contributing significantly to combating corruption in procurement. The General Procurement Principles for UN agencies require all procurement officials in these agencies to maintain an unimpeachable standard of integrity in their business relationships, both inside and outside the organizations in which they are employed, and not to use their office for personal gain. The amendment made by the World Bank to the standard bid documents in October 1996 requires the borrowing countries, as well as bidders, suppliers, and contractors, to observe the highest standards of ethics in the procurement and execution of such contracts.

The guidelines of all UN agencies and many bilateral donors require that the bidders shall not be under a declaration of ineligibility for corrupt and fraudulent practices. ADB encourages the borrowing country to introduce, in the bid forms for large contracts, an undertaking by the bidder to observe the country's laws against fraud and corruption in competing for and executing the contract. The World Bank will disqualify a firm indefinitely or for a stated period from contracts for World Bank-financed projects if it finds that the firm has engaged in corrupt practices.

Bidders are also required to furnish information on commissions or gratuities paid to agents relating to the bid and to certify that they have not given or received any gifts, commissions, or payments other than those shown in the bid. It is too early to evaluate the impact of these measures.

Building Capacity for Public Procurement

As Walsh and Leigland point out (in Perry 1996), the skills and professional standards of the procurement officials, while not easy to attain, are the most effective safeguard against irregularities and graft. It is risky, and unwise in the interest of building up long-term skills, to rely fully on external consultants to operate the procurement system. And, as noted earlier, the procurement function should be made a part of the required competencies of senior managers, and efficient discharge of this function should be made a performance requirement of senior management.

Postaward contract administration and monitoring require special skills to ensure that the contracting obligations are met on time and to resolve problems. Legal skills are required to interpret contracts and to pursue complaints before arbitrators and the courts. The central procurement agency should help the departments to maintain current information on technical aspects, contract law, management, and procurement practice, and finance the attendance of civil servants in procurement courses; rotation, promotion programs, and the lateral recruitment of experienced individuals from the corporate sector and universities for managerial positions; and develop procurement internship programs.

Countries need to incorporate modules on procurement management in their civil service training. Donor agencies could promote these efforts and assist in the transfer of training expertise from developed countries.

Government agencies have the additional responsibility of initiating and assisting in the professionalization of small contractors, and building the capacity of voluntary agencies and community organizations at the local level to handle service and small work contracts.

Chambers of commerce and contractors' associations in different countries could also develop networks and transfer good procurement practices and training programs for their members and for government procurement managers.

In highly politicized operating environments, honest and efficient procurement demands that civil servants be protected from political "suggestions" and provided the security of adequate compensation, swift penalties for violators of the rules, and protection for whistle blowers.

KEY POINTS AND DIRECTIONS OF IMPROVEMENT

Key Points

Government procurement of goods, services, and public works accounts for a large proportion of public expenditure in all countries, and is one of the major sources of corruption in many countries. Clearly, the procurement function is very important, and yet it typically does not receive commensurate attention from senior leadership in most governments.

The government and the private sector differ significantly in the way they conduct their purchasing operations. The main criterion for sound procurement in both sectors is *economy*, i.e., the timely acquisition of goods and services of a given quality at lowest cost. In public procurement, however, other criteria also apply: import substitution, fostering competition, and protecting the consumers. In most countries, environmental considerations and additional social criteria, such as affirmative action for small business, minorities, women, and depressed regions are also relevant.

The legal framework for public procurement consists of general contract law, specific procurement regulations, and procedural manuals. The framework has been shaped in recent years by the international trade regime and the advocacy by multilateral donor agencies of guidelines to prevent corruption and fraud.

In managing the public procurement process, centralization is required for setting the standards, monitoring the outcomes, and providing an appeal mechanism. It may also be advisable in the short run to retain central procurement of strategic and critical supplies such as information technology. In most cases, however, actual procurement operations should be decentralized to the ministries and agencies concerned within the framework of central procurement standards, rules, and oversight.

Procurement procedures must be clear, simple, and made available to the public. Procurement decisions should be recorded and communicated in writing, along with the reasons behind them. Accountability agencies should be able to determine after the fact who made the crucial decisions and why. Tender opportunities in large contracts should be widely publicized, to attract an adequate number of qualified

bidders. Shared databases on contractor performance are needed at national and regional levels to limit the likelihood that the wrong contractors will be selected, and to weed out contractors with a record of dishonesty or incompetence.

Competitive bidding is the rule in public procurement. However, there is justification for giving preference or set-aside quotas in local contracts for goods and services to small businesses and informal enterprises, cooperatives, and disadvantaged groups, provided the costs are not excessive and that unsustainable subsidies are not required over time. Also, construction contracts for local works and services lend themselves to direct contracting to community associations, without competitive bidding. Some degree of domestic preference is also legitimate for developing countries, as recognized by international organizations, to boost local businesses and small suppliers' capacity. Governments should avoid, however, cost-plus direct selection, or the captive purchase of the production of ailing public enterprises to enable their survival.

As mentioned, competition is the rule in public procurement. Private sector procurement, instead, relies to a large extent on semipermanent commercial relationships with specific suppliers. The different forms of procurement are international competitive bidding, national competitive bidding, shopping, and direct (or sole source) selection. For large purchases and contracts, competitive bidding is almost always preferable. The stages of competitive bidding include setting of clear specifications; issuing public notice and invitation to bid; bid opening and evaluation; and contract award and conclusion. The process must incorporate safeguards to ensure its integrity and impartiality, and to prevent collusion, corruption, and fraud.

After the contracts are concluded, they must be carefully monitored. Several types of controls and reporting, including audits and citizens' complaints, can be used to deal with contractual problems, but there is no substitute for close government supervision of the execution of a clean contract.

Directions of Improvement

In developing and transitional economies, improving the procurement system to meet standards of economy, competition, accountability, and honesty generally requires moving to

- simplified legal and regulatory framework for procurement;
- clear organizational arrangements, combining centralized procurement policy/oversight with decentralized operations;
- improved public access to information and documentation;
- measures to ensure that only civil servants of competence and integrity are in charge of government procurement, and providing for commensurate rewards through career options and frequent rotation;
- simple and transparent process of procurement, whichever method is chosen;
- more effective mechanisms to curb fraud, abuse, and corruption, with appropriate assistance from international organizations; and
- more attention to contract execution and monitoring.

In many developing countries, efforts to close loopholes for corruption or to achieve social goals have created increasingly detailed regulations and centralized control. The problem is especially acute for the acquisition of technology and other products that change rapidly and have a short product cycle. A major improvement would be to review the value thresholds above which the complex bidding rules apply in their entirety, and to raise these thresholds with inflation. In many developing countries, low-value items make up the bulk of procurement, especially in local government and field offices, and complicated regulations intended to prevent the misappropriation of very small sums generate far greater transaction costs for both the government and the private supplier. Worse, as noted in Chapter 1, they are usually ineffective in preventing large-scale corruption, precisely because of their complexity and the resulting delays, discretion, and lack of transparency. The main direction of improvement is to achieve a better balance between controls and managerial flexibility. Most developing countries need fewer but clearer and more robust rules, together with swift and predictable enforcement.

In developing countries, the uneven documentation and bidding procedures of different government entities compound the problem of excessive controls. Standard bid documents for goods and services, as well as work contracts, are in fact enforced for donor-assisted projects. Major

improvements in economy and integrity would result from extending such standard bidding documents to all government procurement because their use reduces opportunities for undue discretion, collusion, and extortion. Developing countries can also benefit from external assistance to improve the regulatory and organizational framework, and build capacity in their procurement offices, but should not rely mainly on external consultants for actual procurement operations.

Other improvements in procurement in developing countries could be realized by addressing the slowness of the dispute resolution mechanisms. The process is slow partly because of weaknesses in the judicial system and partly because of the complex appeal procedures. The process of recovering money from suppliers in case of bad performance or default is cumbersome and often fruitless because of antiquated foreclosure laws and the manipulation of bankruptcy laws by defaulters. Contractors also face protracted legal battles in recovering disputed sums from government. With the government and the contractors thus forced to take steps to protect themselves from these eventualities, transaction costs increase for both sides, making the purchase of goods and services, and contracting, much more costly in the government than in the private sector. Overall weaknesses in the judicial system are a broader problem, which could be dealt with by establishing a streamlined and fast-track procedure for appealing administrative court decisions on procurement disputes.

Finally, although the process of procuring goods, services, and works is critical for the economical and effective use of public funds, procurement issues have not received much attention from senior public managers and political leaders. In part, senior managers are not interested in the mechanics of procurement; they are also concerned with keeping their distance (and deniability) from potential waste or corruption scandals. Yet, they must realize the great importance of procurement in an efficient, effective, and honest government, and place it at the center of their responsibility rather than shunting it off to lower-level staff. In turn, political leaders must give them their support in the exercise of this delicate responsibility.

Annex V

**UNCITRAL MODEL LAW ON PROCUREMENT OF
GOODS, CONSTRUCTION, AND SERVICES¹⁸**

**WITH
GUIDE TO ENACTMENT**

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NOTES

- ¹ This section has drawn mainly on Transparency International (1996); Walsh and Leigland in Perry, ed. (1989); WTO statistics; internal ADB memoranda and country profiles; Kettl, et al. (1991); Dehoog in Cooper and Newland, eds. (1997); and Commonwealth Secretariat (1995a).
- ² The World Bank, for example, has stipulated the use of a separate set of documents for construction contracts.
- ³ Following the adoption of Agenda 21 in the International Conference on Environment and Development in 1992.
- ⁴ This section relies partly on WTO statistics; OECD (1997e, 1999a); Sherman (1987); Dehoog in Cooper and Newland, eds. (1997); and internal ADB memoranda and country profiles.

- ⁵ The commission is a UN agency set up to promote the harmonization of international laws relating to trade. It has formulated other model laws on international commercial arbitration and conciliation, international sale of goods and related transactions, cross-border insolvency, international payments, international transport of goods, electronic commerce, and international construction contracts.
- ⁶ This section has drawn partly on Dehoog in Cooper and Newland, eds. (1997); Perry (1989); WTO statistics; Corrigan et al. (1999); and internal ADB memoranda and country profiles.
- ⁷ This section has drawn from Walsh and Leigland in Perry, ed. (1989); Dehoog in Cooper and Newland, eds. (1997); OECD (1999a); internal ADB memoranda and country profiles; procurement guidelines issued by the World Bank and the Asian Development Bank; and details of national practices available in the statistical data published by the World Trade Organization.
- ⁸ These may include procurement from UN agencies, procurement in loans to financial intermediaries, procurement under build-operate-transfer and similar private sector arrangements, and community procurement.
- ⁹ Prebid action in the case of construction and works also requires the prior assembly of land and site where the work will be performed.
- ¹⁰ Donor organizations normally publish these in both paper and electronic forms, as, for example, the *Asian Development Bank Business Opportunities*.
- ¹¹ The fee charged for the documents should be reasonable and should reflect only the cost of printing and delivery, and not so high as to discourage small bidders. Bid security should also not be set so high as to discourage bidders. The security could be in any acceptable form, such as a certified check, bank draft, letter of credit, or cash.
- ¹² The description is based on the published guidelines and bid documents of the World Bank and the Asian Development Bank.
- ¹³ See Schiavo-Campo and Singer (1970).
- ¹⁴ This section relies mainly on Sherman (1987); Dehoog in Cooper and Newland, eds. (1997); and Rehfuss (1989).
- ¹⁵ This section was drawn in part from Stockholm International Peace Research Institute (1999); Gregory (1989); Brazoska (1999); and Jones (1999).
- ¹⁶ This section was drawn in part from Pope, ed. (1996); Cooper and Newland, eds. (1997); Walsh and Leigland, in Perry, ed. (1989); Tanzania (1996); Mccampbell, et al. (1997); and World Bank (1997).
- ¹⁷ Although even this pales in comparison to the single most efficient and least verifiable form of corruption by far: privileged access to undervalued foreign exchange, which is then sold at a premium on the informal market, for a riskless, costless, and almost instant profit. Procurement is a major source of corruption, but is by no means the only one.
- ¹⁸ For a detailed treatment of the model, the interested reader is referred to (<http://www.uncitral.org/english/texts/procurem/mlprocur.htm>).