

Performance and Policy-Based Budgeting: How to Spot the Fakes ¹

In the allocation of scarce public resources, good budgeting is an art and a skill. It is a core function of government, and as such, it is fundamentally a political process with many competing objectives.

But from a technical perspective, how do we know if a country's budget system is actually any good?

A budget is good if it meets policy objectives - and therefore the needs of the citizen – with the efficient, effective, and sustainable use of scarce resources. A hard budget constraint is also a key part of a good budget that should be used to promote a competition of ideas that win access to scarce resources. There are several internationally recognized public finance system diagnostics that go into more detail on what a good budget is and indicate the health of a government's budget system. For example, there is the Public Expenditure and Financial Accountability (PEFA) framework that assigns letter grades to system quality from A to D, or best to worst. PEFA looks at various parts of the budget system to assess how believable a budget is, how transparent the disclosures are, and how orderly the budget process is run, among other aspects. The Open Budget Index (OBI) focuses on the transparency of the budget of a central government. The index scores open budgeting performance using a 100-point scale based on a number of questions on timeliness of budget disclosures in accordance with good practice standards. Other tools include Fiduciary Risk Assessments (FRA), Open Government Partnership (OGP) and the International Monetary Fund's (IMF) Reports on the Observance of Standards and Codes (ROSCs) related to fiscal transparency. The purpose of this note is not to review these diagnostics, but to help practitioners, the media, and other stakeholders be aware of some of the practices that may indicate a budget is following good practice, when in reality it is not. Moreover, there are government systems

References:

1. By Andrew Laing, Public Economics Practice Manager, Institute for State Effectiveness. Valuable comments from many colleagues including Vincent Ashcroft, Peter Muir, Tony-Preston Stanley, Malcolm Holmes, Richard Allen, Teresa Curristine, Scott Guggenheim, Clare Lockhart, Pat Austria, Gracia Angulo, Nelly Mecklenburg, Alex Park, Brendan Kilpatrick and Lauren McCollough. This DPN was published in December 2019. It updates the first version of published in August 2019.

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that claim to be using performance and policy-based budgets, but they are often that in title only. These are what are called the “fakes.”

It is important for practitioners to be able to recognize the fakes, to know what is really required to earn that title and be able to bring a system up to best practice. In many cases the presentation of the budget is arguably more about making it look like there is accountability when the opposite is true. That said, there is always some degree of evolution involved. For example, some budgets build up slowly from a foundation, while others make progress when political windows of opportunity open. What is always important is the commitment to the goal which is multi-faceted – being transparent and accountable in the pursuit of good outcomes for citizens from public spending, revenue raising, and asset and liability management.

This note is atypical in that it attempts to explain what good performance and policy-based budgeting is and how to spot potential fakes. To do this, the foundation for modern accountability frameworks is reviewed. This foundation is the democratic system where government is held to account through elections. This note then explains two of the best practice budgeting systems separately: policy-based budgeting and performance-based budgeting. For policy-based budgeting, key concepts are outlined, and the methods used to run a policy-based budget process are elaborated. For performance-based budgeting, the key elements of such a system are highlighted including a description of how it supports good governance and accountability through institutionalized learning and continuous improvements, which arise from an annual cycle of announcing promises and reporting on results. The note ends with a list of 12 red flags that indicate if the budget is a “fake” and worthy of deeper inspection. For example, fakes are likely to have implausible estimates of fiscal aggregate figures (revenue, expenditure, and budget balance) over the medium term.

To explain policy-based budgeting to non-economists, the three simple statements below provide a good overview

References:

2. Bad policy is defined here as one where the benefits are less than the costs of following it, including in comparison to other existing or new policies. A bad policy also contributes to fiscal risk and instability, without the commensurate public benefits. A corrupt policy is an example of a bad policy, where the benefits of the policy are enjoyed by a small few at the expense of the many.

of what policy-based budgeting is actually about:

1. Policy-based budgeting helps to ensure that only good evidence-based ideas get funded;
2. Policy-based budgeting looks into the future to solve difficult problems; and
3. Policy-based budgeting makes it harder for people to get away with corruption or incompetence.

Similarly, to explain performance budgeting to non-economists, the three simple statements below summarize the concept:

1. Performance budgeting gives clarity to citizens, officials, and other stakeholders about what the government is trying to achieve with the people’s money;
2. Performance budgeting helps ensure that there are consequences for good and bad performance; and
3. Performance budgeting helps make government responsible for its promises and results.

THE FOUNDATION FOR GOOD GOVERNANCE AND ACCOUNTABILITY

The democratic system is the foundation for good governance and accountability. Accountability is about making performance visible to someone who has specific authority to call government to account for that performance. Most importantly, accountability is fundamental to good governance in modern, open societies. Democracy is the system where the people ultimately hold government to account for its performance through the electoral system, where the people have the power to choose representatives to govern and protect their interests. Figure 1 below demonstrates how this accountability system works in the public sector where the administration is accountable to the executive and the legislature. The figure also shows the

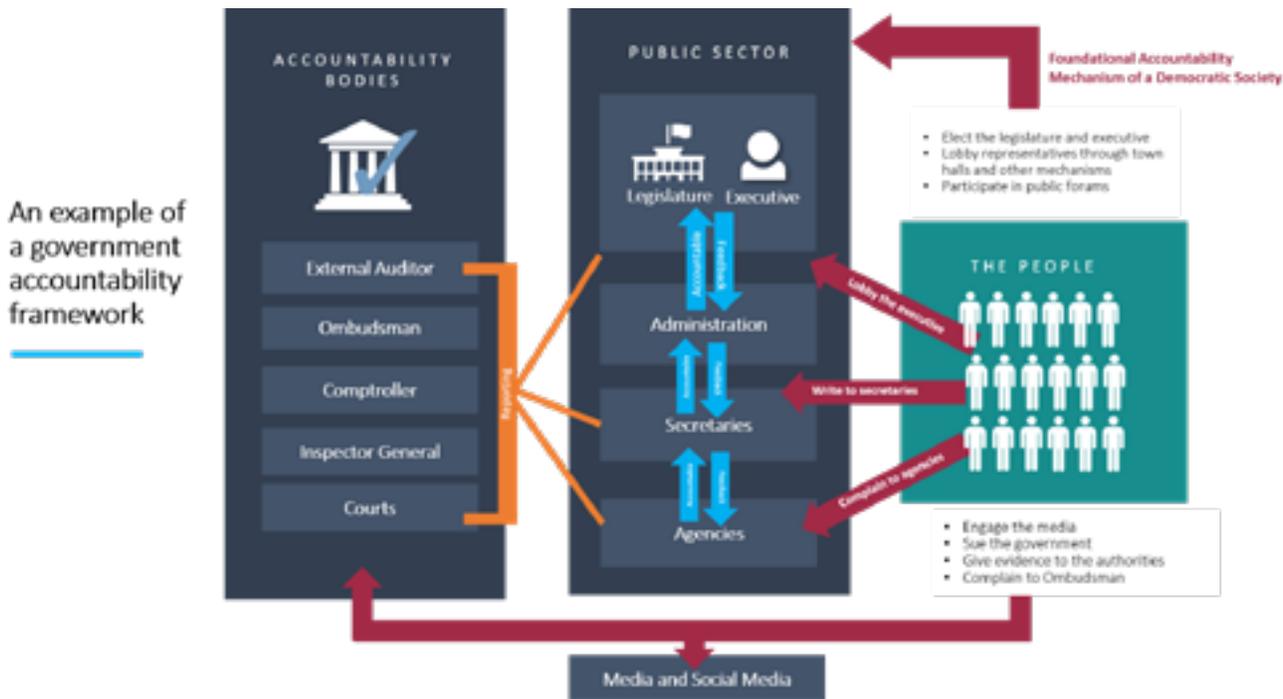


Figure 1: Policy Based Budget Supports the Accountability Framework

links in secondary areas of accountability where people can hold government to account in the space between elections by lobbying the executive, writing to ministers/secretaries, or submitting feedback directly to agencies. Other avenues for accountability include approaching the media or using social media, as well as seeking assistance through formal accountability bodies such as the courts, ombudsman, and auditors.

KEY CONCEPTS OF POLICY-BASED BUDGETING

The point of policy-based budgeting is to help ensure that the budget process focuses on the policy priorities of government as the basis for allocating resources, rather than other areas, which may be driven by less efficient or effective alternative mechanisms. Figure 2 demonstrates the aims of policy-based budgeting in more detail by taking key public finance concepts and showing how these operate in the budget preparation setting. The figure shows policy makers making decisions on government fiscal policy, i.e. what the Government does to raise and spend revenue. The main aim of this type of budget is to deliver a resource allocation system where there is fully informed decision-making based on a solid evidence base and the cost of inappropriate decisions is made as high as possible. The idea behind this is that the system is designed to try to keep bad policy out and only let good policy into the budget.

When the system is working well, not only does bad policy not get through easily, but bad practices such as corruption, nepotism, and patronage are weeded out and prevented from capturing resources and sponsoring bad policy.

Good policy gets through because of good fiscal rules (how policy is costed and evaluated) and **good fiscal gatekeeping** (how bad policy options are prevented from entering into debate at the highest levels of government).

This is about raising the bar by making sure evaluations are done properly, due process is followed, and parameters are used consistently. Of course, the process cannot catch everything and nor should it, given the political process in which it takes place. Sometimes officials get it wrong and are too conservative or are captured themselves. Nevertheless, it is important to have a solid evidence base, good advice, and strong processes. Rules-based systems only work if those rules are followed and enforced.

Gatekeeping can be in the form of a gateway appraisal system and/or simple check lists. For example, if due process has not been followed the new policy idea is not allowed to be debated by cabinet. Due process check list examples include: i) Has the policy been properly costed and supported by an economic evaluation that has been independently validated?; ii) Has consultation taken place with all relevant agencies and other stakeholders and have stakeholder views been included in the new policy

proposal budget submission?; and iii) Has an appropriate amount of time been given to stakeholders to form views? Gatekeeping systems can also be supported by information technology. For example, preventing budget passage of submissions through online systems unless all due process steps have been followed.

Policy ideas also come from the implementers or the agencies. They provide important reality checks on ideas coming from the top. Implementers are often in a much better position to assess the viability of a policy that

within the public sector, governments should always try to raise revenue at the lowest economic and social cost – “where it hurts the least.” Considerations here include the costs of disruption to the economy and hardship on the people. For example, a high resources/oil tax might encourage mining companies’ to base their headquarters elsewhere, driving down tax revenues, disrupting mining industries, and reducing jobs and economic activity. Another example is instituting a high consumption tax on food, which hurts the poor more than a low wealth tax. This issue is reflected in the left side of Figure 2.

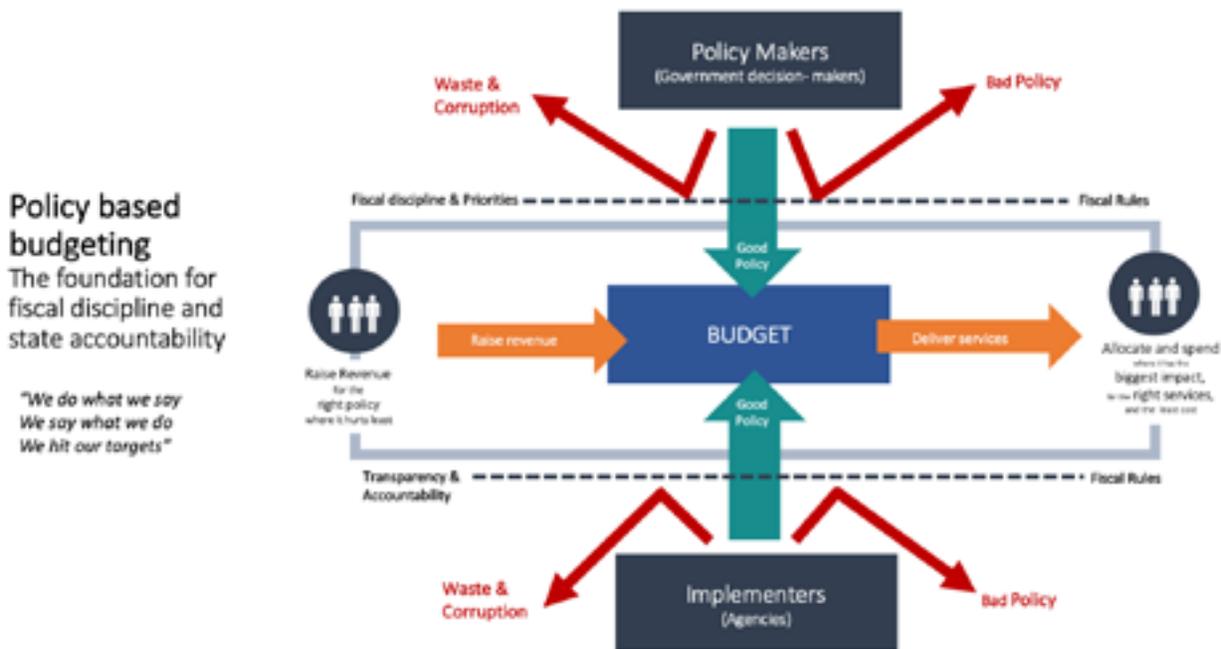


Figure 2: Good Budgeting – Delivering Efficient and Effective Governance

originated from the top. This can be thought of as the bottom-up component, which provides a counterweight to the top-down resource allocation process. A crucial part of the bottom-up process is the stakeholder consultation process that includes involvement of the beneficiaries in the development of policy and its implementation. Those to which the policy will impact should always be properly consulted.

At the same time, key components of economic efficiency are influenced through this system. Foundation principles of public finance apply here. For example, for efficiency

On the right side of the Figure 2 we have the budget providing resources to deliver services to the public. There are foundational public finance principles present here. Governments need to: i) allocate resources where it will have the biggest impact (allocative efficiency); ii) ensure that those areas that deliver the biggest impact actually receive the resources (distributive efficiency); and iii) maximize value for money, meaning that when money does get spent on services, it gets spent at the lowest cost (technical or operational efficiency). Too much spending compromises the viability of future government finances,

risking bankruptcy and defaults. Too little spending may mean too many people suffer when that need not be the case. In sum, all “good” public sector budgets are supposed to deliver efficient and effective services in an inclusive and sustainable way.

SIX KEY CONCEPTS

There are six key concepts in policy-based budgeting that are crucial for getting the system to work as intended. These are: i) **Fiscal Discipline** to drive good fiscal performance; ii) **Fiscal Space** to provide room for new and better policies; iii) **Medium-term budget perspective** to resolve difficult problems and deliver certainty of funding for existing policy over the medium-term; iv) **Separation of existing and new policy**; v) **Systemic evaluation to drive**

orderly the budget process is run, how well budget rules are complied with, and the extent to which the budget preparation system is respected (e.g. spending proposals outside the annual budget process are kept to a minimum). Fiscal discipline can be achieved by focusing on policy in the budget process.

Fiscal space is the room for new policies. In a policy-based budget process, budget formulation involves the reconciliation of a range of different political and technical objectives and their resource implications, based on the relative priority of existing and proposed programs. In other words, every year low priority, low impact activities should try to be replaced with higher priority, higher impact activities. To successfully do that, an annual review of fiscal space

Policy based budgeting

To solve difficult problems and deliver fiscal sustainability you must look to the future

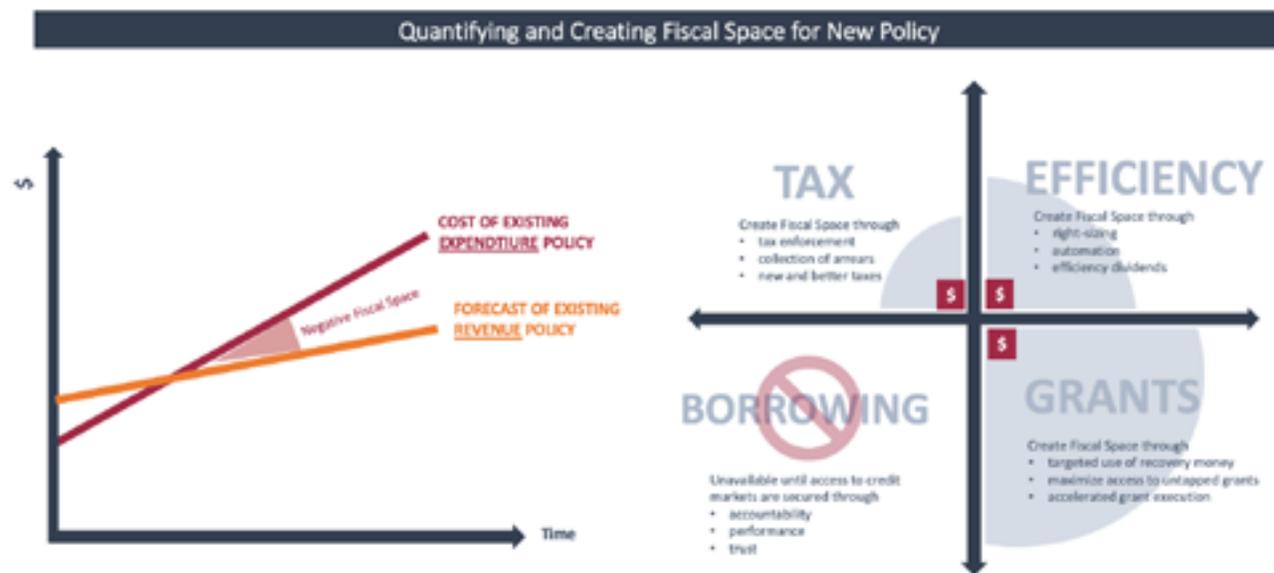


Figure 3: Five Dimensions of Fiscal Space

continuous improvement; and vi) **Rolling forward estimates** for better budget building.

Fiscal discipline is about ensuring that fiscal performance targets are set and met. Aggregate fiscal discipline, for example, focuses on ensuring fiscal aggregates (high level budget targets) are achieved, budget deficit/surplus targets are complied with, and revenue and expenditure targets are realized. Other forms of fiscal discipline include how

is required. Fiscal space needs to be estimated, and new fiscal space needs to be created by, amongst other things, removing ineffective or low priority spending to make way for “better” spending.

There are five dimensions to fiscal space to which government can influence - the first fiscal space dimension is time. The left graph in Figure 3 demonstrates

this form of fiscal space. Here fiscal space is the difference between the forecasts of existing revenue-raising policies and the estimated costs of existing expenditure policies. Often, there is negative fiscal space as shown in Figure 3. This can be the case when annual budget systems fail to properly account for the future costs of fiscal policy decisions. (See 2003, M. Holmes and A. Evans on A Review of Experience in Implementing Medium Term Expenditure Frameworks in a PRSP Context: A Synthesis of Eight Country Studies).

The other four dimensions of fiscal space are shown in the right graph of Figure 3. There are four levers that governments can use to create fiscal space. It can raise more revenue, of which taxes are usually the greatest source, increase efficiency (e.g. by doing more with less or by removing spending on low priority and ineffective programs in favor of higher priority more effective programs), seek access to grants (e.g. aid or grants from federal government or monetary unions/trade blocks), or borrow more. (See 2005, P. Heller, Understanding Fiscal Space). Every year a process of fiscal space quantification, creation, and filling takes place in a policy-based budgeting process. If done well, a sound and continuous improvement cycle is created.

The third key concept is having a medium-term perspective in budgeting, as it is essential to help solve difficult and intractable problems and deliver certainty of funding for existing policy over the medium term. This is probably the most critical component of policy-based budgeting. Difficult problems take time to solve and cannot be addressed within a single year time horizon. To solve difficult problems there needs to be a good degree of certainty of funding for existing policies to achieve their objectives over the medium term. This is intended to encourage planning and efficient and effective implementation. Most new government policies take years to bed down and deliver intended results. During subsequent budget processes, these existing policies would be tested to see whether they are “working”. Here the medium-term for budgeting can be two to three years after the next budget year that is being prepared. In 2009, Holmes wrote that “an annual approach to national budgeting actually undermines budgetary performance, contributing to fiscal instability and, perhaps even more fundamentally, to resource misallocation and the inefficient

and ineffective use of resources.”

The fourth key concept is that policy-based budgeting is characterized by the notion of the separation of existing and new policy. Budgets need to reflect the fiscal impacts of existing policy – now and into the future. “Forward year estimates” are essential under this system. These forward estimates are the approximations of the fiscal impacts of existing policies, which are in turn based on a set of rules of how estimates are agreed on and reflected in the budget. New policy is considered every year, and once fiscal impacts are agreed to by the leadership, they are added to the forward estimates to create a new budget. New policy can be a new program or activity, a significant change to the existing policy, both revenue or expense measures, or even savings measures. Costing of new policy is based on full life-cycle methods that incorporate both capital and future operating costs. This results in multi-year fiscal impact evaluations of new policy proposals that cost both capital and current costs now and into the future. If costings are not done properly then policy is not properly reflected in the estimates and budget blowouts can become the norm. What all this means is that there is no need to revisit the whole budget every year. Once a policy is approved and if it does not change then it does not need to be reviewed annually. Changes in policy are the primary focus of the annual policy-based budget process.

Policy-based budgeting requires a holistic approach to resource allocation. Questioning the continued relevance of existing policies is a critical component of policy-based budgeting. Program evaluation is the systematic, periodic assessment of a program or activity in order to inform management on: i) the continued relevance and priority of program objectives in light of current circumstance and government priorities (appropriateness); ii) whether the program outcomes achieve their stated objectives (effectiveness); and iii) explore whether there are better ways of achieving the objectives (efficiency). These issues should be formally addressed in the fiscal space creation exercise described earlier, but also through more detailed periodic reviews of agency and program performance.

The sixth key concept - a crucial element for effective policy-based budgeting - is the use of “rolling forward estimates”. The principle of rolling estimates is that the first forward

year becomes the baseline for the new budget year. Figure 4 demonstrates how the system of rolling forward estimates works in a policy-based budget process. To start, the system makes allocations for the next budget year and three subsequent forward years. These are the costs of existing policy on the expenditure side – see the top left graph in Figure 4. Then new policy proposals are considered. In this example there is a new hospital program. Independently validated costings indicate that it will cost \$35 million in capital to build the hospital and then \$5 million per annum to run it. Economic evaluations indicate that the cost-to-benefit ratios are less than one and so it delivers value for money. Compared to other proposals, the evaluation was seen as the best use of limited resources –it had the lowest cost-to-benefit ratio and highest internal rates of return. Once the cabinet/executive agree to the proposal, it is locked into the budget and the forward estimates of existing policy. Current year new policies become existing policy in the next budget year. In the top right graph of Figure 4, this is represented as the red boxes being added to the budget baseline

Rolling forward estimates in this budget system means that the first forward year estimates are rolled over to form the baseline for the new budget year. This is illustrated in the bottom right graph of Figure 4. Changes to the budget and the fiscal strategy should be fully explained in budget papers. Genuine (or non-fake) policy-based budgets are very clear on what changes to the budget and fiscal strategy were caused by:

1. Parameter variations (e.g. due to differences in estimates of the effects of inflation);
2. Estimates variation (e.g. due to differences in estimates of the effects of changes in key cost drivers like number of beneficiaries); and
3. Changes in policy - a new policy decision by the government (e.g. a new tax policy or a decision to buy some new fighter jets) or a decision to cease funding for an existing program.

Rolling over of forward estimates is still not sufficient.

Every few years, the medium-term baselines (forward year

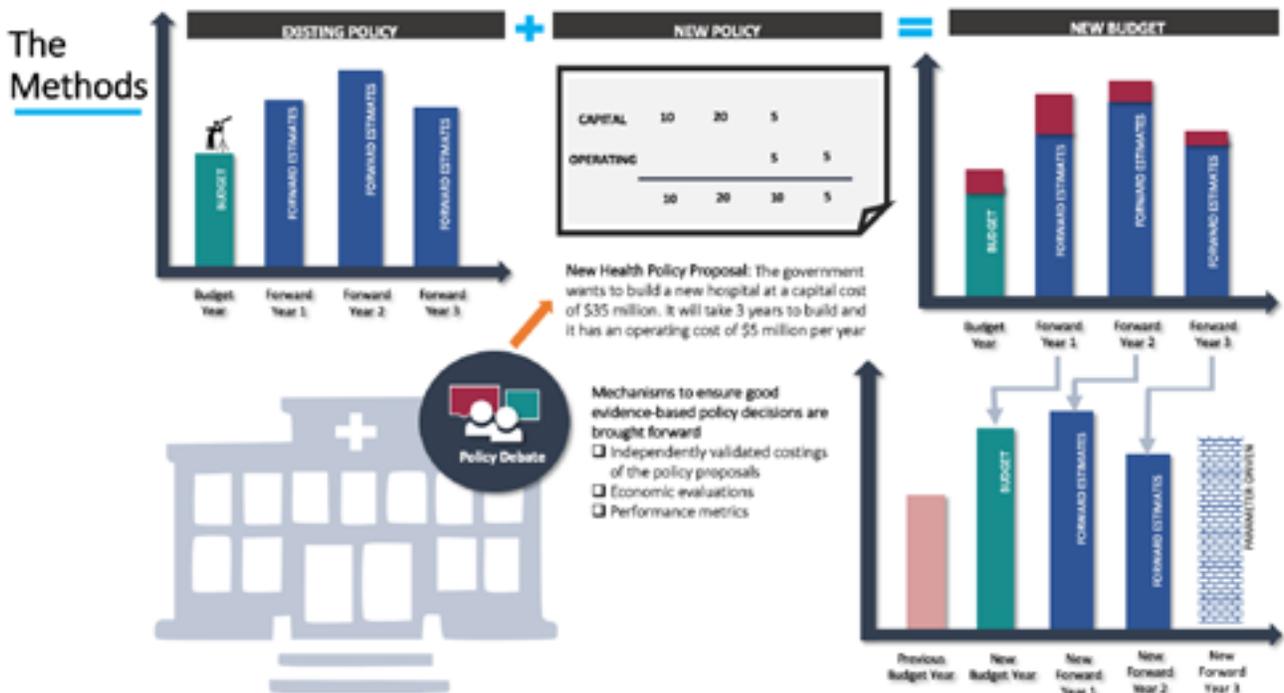


Figure 4: The Methods – Rolling Forward Estimates and Policy Change

and forward estimates. The actual rolling over of forward estimates happens the following year.

estimates) should be checked for accuracy of the true costs of all existing policies of an institution or budget holder. In development terms, this is akin to the costing the sector

strategies. In good public finance terms, it is the costing of agency (or ministerial portfolio) policies. These can often have different names like public expenditure reviews, pricing reviews, functional analyses, zero-based costing, or efficiency assessments.

emerged from the program-based budgeting system that was introduced in the 1960's, which was based on the idea of linking budget allocations and management to results. (See 2016, D. Moynihan and I. Beazely in *Toward Next-Generation Performance Budgeting - Lessons from the*

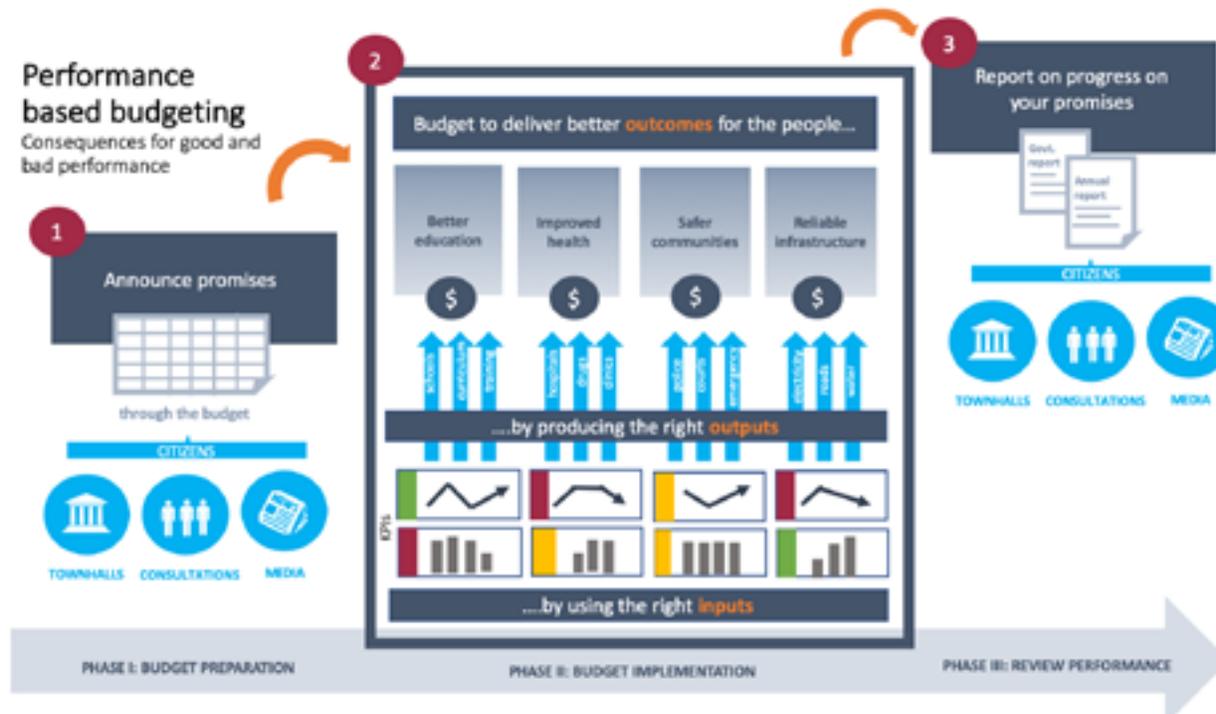


Figure 5: Performance-Based Budgeting – Announcing Promises and Reporting on Results

PERFORMANCE BUDGETING

Performance Budgeting is fundamentally about learning and helping a government to be accountable for delivering on their promises. Learning about both financial and non-financial performance over time is a key focus. In performance-based budgeting there needs to be both learning – where institutions systematically get better at what they do over time – and accountability – where there are consequences for good and poor performance. The focus is on making the public sector more efficient, effective, and accountable for its performance, and on improving the responsiveness of the public sector to the needs of its clients – the citizens.

The system is built on the idea of an annual budget cycle that starts with announcing fiscal promises and ends with reporting on actual results. Performance budgeting

Experiences of Seven Reforming Countries). The system is designed to inform the continuous improvement cycle and make it work as intended (see Figure 5).

Under performance budgeting, government leaders announce their fiscal plans every year through the annual budget. These can be thought of as fiscal promises to the people. The announcement of promises is stage 1 of the process shown in Figure 5. Since the budget is the expression of fiscal policies, budget papers should clearly show what is being done with the money, where it is going, and what is hoped to be achieved.

Under advanced systems, not only does the government issue a set of budget papers for the government as a whole, but ministers/secretaries also issue a set of budget statements explaining what is happening with the money in much more detail under their portfolio (also known as Portfolio Budget Statements, or PBS). When

this happens the government and individual ministers and secretaries become directly accountable for spending government resources. **These budget papers can also drive the system of how government representatives engage citizens** through, for example, roadshows, townhall meetings, stakeholder consultations and social and traditional media.

factors might ultimately determine if good outcomes are achieved. Clearly, it is not fair to hold people to account for performance in areas that are not within their direct control. So, under performance-based budgeting, the budget is split up further into “outputs” or deliverables, which are supposed to help achieve the desired outcomes. Outputs

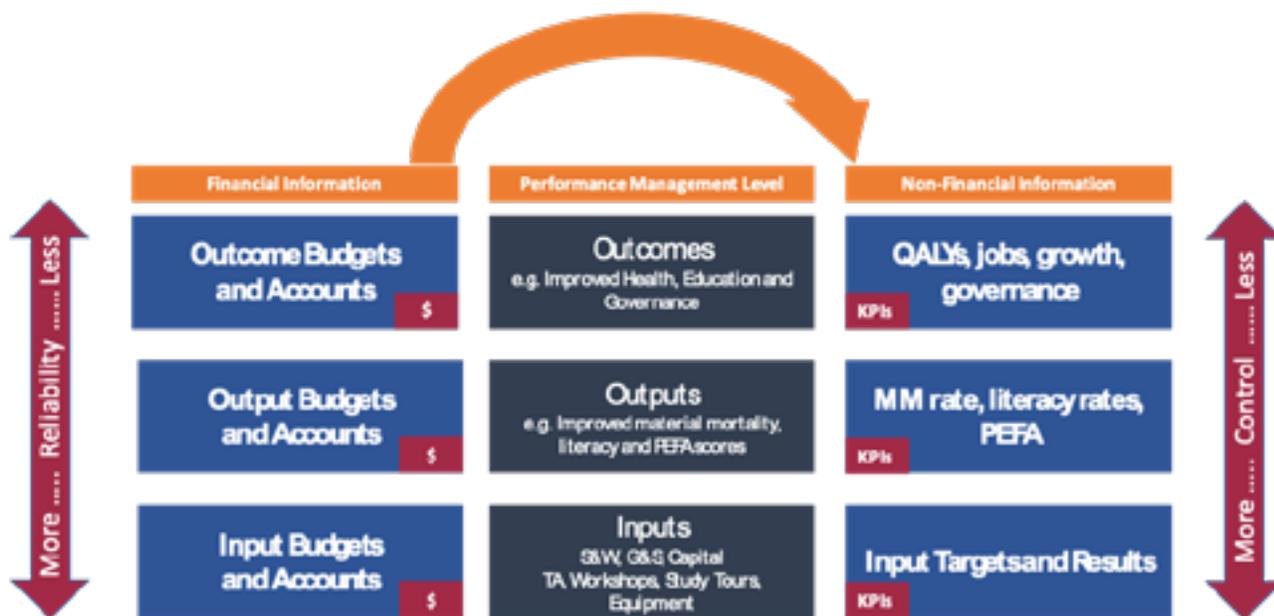


Figure 6: Performance Budgeting Bringing Financial and Non-Financial Information Together

The key component of performance-based budgeting is how it reports non-financial and financial performance.

This is demonstrated in stage 2 of Figure 5. In this example, the budget is split into a set of objectives and deliverables, sometimes called outputs and outcomes. Different forms of performance budgeting use different terms, such as purposes and programs and sub-programs and activities, but the idea is essentially the same: split the budget up according to deliverables and track both financial and non-financial performance. It is important to differentiate between outputs and outcomes. In education ministries, for example, more spending might yield outputs of more books and classrooms, and outcomes could be better education, higher literacy, and better job prospects for children. Outcomes have performance metrics that indicate whether the situation is getting better or worse and can be thought of as the purpose or benefits of spending.

High-level performance outcome indicators aren't always under the complete control of the government as external

are more in control of agencies and the teams within the agencies. Similarly, there are performance metrics tied to these outputs that allow teams to know their responsibilities. These metrics need to be able to be used routinely to assess the performance of people, teams, and institutions that are tasked with getting the job done. If the information is not used to manage and drive a performance culture, then the system will almost certainly fail to deliver better outcomes and the exercise will be one of compliance rather than real performance management. The issue of control is elaborated in Figure 6, which reveals the relationship between financial and non-financial information and control and reliability of information.

Under performance-based budgeting, input-based budgets still exist. Input-based budgets should not be replaced by output-based budgets. It is still very important to know what is being bought – how much is being spent on salaries, consultants, utilities, and capital, for example. Moreover, reporting of expenditure against international

standards for the Classifications of the Functions of Government (COFOG) remains essential, as it is the only reliable and efficient way to track and benchmark financial performance over time on the purpose of spending. This international standard splits the expenditure budget according to a well-accepted set of classifications on purpose of spending so that very basic budgeting questions can be answered, like how much is being spent on primary education compared to secondary education, on hospitals

different ways. One of the most recommended and common methods is through the use of bridging or mapping tables. Under this approach, programs, sub-programs, and activities are mapped to outputs directly or through some other methodology that can be formally validated by independent parties.

The third stage in Figure 5 is the reporting of progress against promises. Here, the foundation accountability document consists of the annual report with audited financial

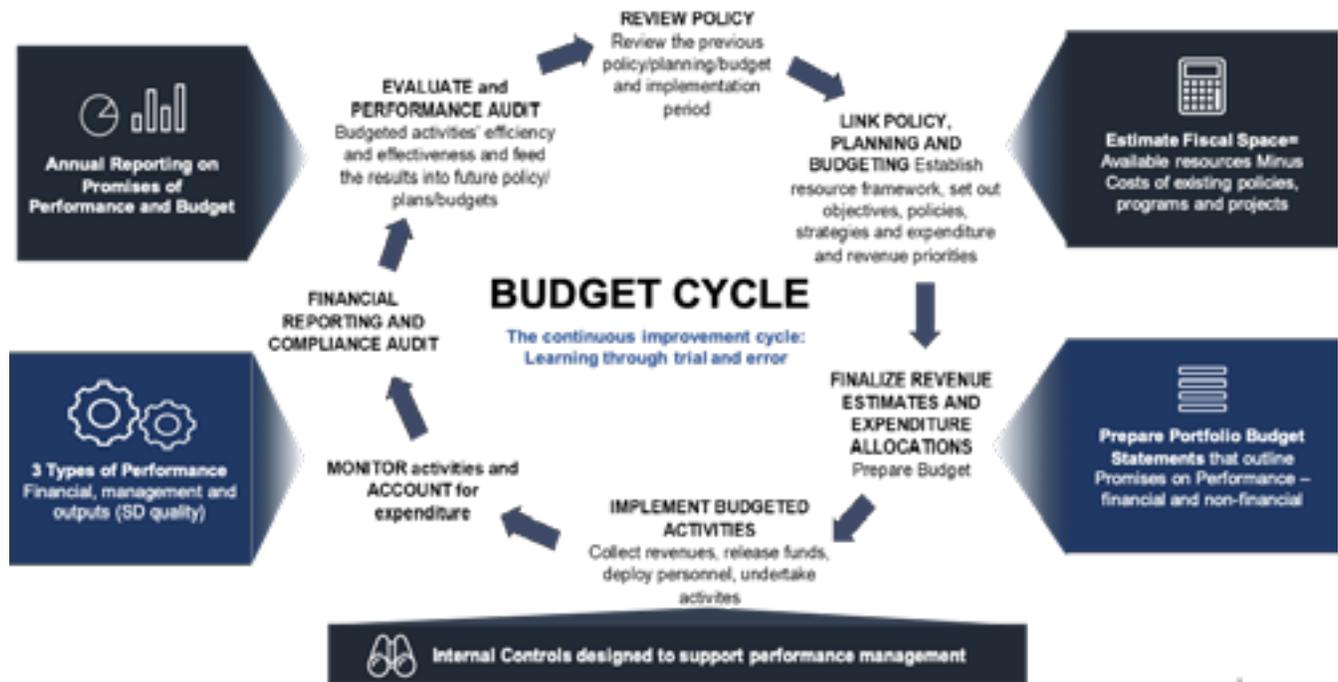


Figure 7: Performance and Policy Based Budgeting Driving Institutionalized Learning

and pharmaceuticals or defense. COFOG provides the standard on how to split the budget up in such a way. It ensures that changes in the structure of government administrations over time do not mislead citizens and stakeholders on what is being done with government resources.

By considering outputs and outcomes, performance budgeting simply cuts the fiscal cake another way. It provides a set of performance metrics to help managers manage and help stakeholders and citizens hold the government to account for their performance. How the cutting of the cake is achieved can be approached in

statements and management’s response to the independent auditor. One of the most crucial parts to this document is that it needs to be comparable to the budget and written in plain language so that any reasonably educated citizen can pick up the budget papers and the annual report and easily compare the fiscal promises made over a year ago with the results achieved. This simple but powerful principle is often ignored.

Annual financial reports can be difficult to understand by non-accountants and non-economists; the format is often completely different to the budget papers, and the accounting and classification standard are also often

not the same. For example, the Government Accounting Standards Board (GASB) in the United States used for state governments does not require that financial statements be produced in the same form as the budget or vice versa. The International Public Sector Accounting Standards (IPSAS) does recommend that such comparable statements be produced, and as of 1 January 2019 it is now a mandatory disclosure. IPSAS now defines comparability as “actual amounts presented as the same accounting basis, same classification basis, for the same entities and for the same period as the approved budget.”

Like the budget papers, the annual reports set the basis for engaging citizens on what has been achieved and learning lessons from beneficiaries, though, for example, roadshows, townhalls, stakeholder consultations, and the media. There are two major periods in the fiscal year when the government and heads of agencies should be engaging with citizens and stakeholders. First, during the budget preparation phase and, second when communicating results as expressed in annual reports. There is also in-year reporting, but annual reporting of promises and results is the foundation for the continuous improvement/accountability cycle.

One of the key tests to see if a performance-based budget is not a fake is to review the performance metrics used

– both the baselines and what has happened over time. Performance budgets with metrics that do not have baseline performance results of the previous year are a clear warning sign of a fake. If performance targets do not have any historical data, then it is likely that actual performance against those targets will never be reported on – especially by the end of the fiscal year. Collecting performance data takes time and effort.

Another way to spot a fake is to review the results of metrics over time. Actual results of performance metrics that are rounded or exactly the same as the target are both warning signs of fakery. Conversely, results that disappear in some years then reappear in the future may indicate that the performance metrics might not be a fake. In that situation, it might indicate that politics is pulling the poor performance results from the view of the public and stakeholders.

There have been disappointments with performance-based

budgeting. Various efforts to introduce output-based budgets did not result in improvements in fiscal performance. Could it be that the implementation was a fake – was it a distraction reform, where outputs are budgeted for but actual financial results by outputs were not reported on or audited? When this happens, it makes it difficult to compare: i) promises with results; ii) targets with achievements; and iii) financial and non-financial results. In assessing the effectiveness of performance budgeting, there appears to be some evidence to suggest that the implementation of performance budgeting was poor, not that performance budgeting as a concept is wrong.

The failure to realize the potential that performance budgeting promises might be because other core components are missing. Crucial systems like policy-based budgeting, as described here, might be the reason fiscal performance is not improving. For example, the lack of real rolling forward estimates means that there is insufficient time and effort focused on assessing and directing changes to new policy and learning from past performance.

More work is needed to improve presentation of and access to annual financial and non-financial performance information, including targets and results. The idea being that information needs to be presented in a way that makes it very easy for officials, civil society, and other stakeholders to not just assess fiscal performance through traditional means, but also to assess the cost-effectiveness of fiscal policy at a certain point in time, as well as over the long-term.. To do this, financial information and output performance indicators need to be aligned well, and it should be very easy for users to access and analyze the information so that they can quantify things like unit costs, allocation rates, cost-effectiveness ratios, and value for money indicators. Recent studies indicate that “citizens ... really do demand information relevant to public accountability” (see Berliner et al, 2019, “What Information do citizens want? Evidence from one million information requests from Mexico”). So, no difficult to read pdf budget papers and annual reports. All information needs to follow open access standards so that interested readers can easily analyze the information contained in reports.

MERGING THE TWO: PERFORMANCE AND POLICY- BASED BUDGETING

Performance Budgeting and Policy-based Budgeting have the potential to work very well together – but it is not easy. Policy-based budgeting helps to ensure: i) only good ideas get resources; ii) a medium-term view is in place to solve difficult problems; and iii) there are rolling forward estimates that enable policy makers to focus on policy change and policy review through the annual budget cycle. The full cycle of performance and policy-based budgeting is described in Figure 7. Performance budgeting, on the other hand, can help ensure that the right policies are implemented well and improve over time.

Performance budgeting is not about rewarding bad policies that are implemented well. Good performance must be judged on the priorities that have been set. As such, performance budgeting puts priorities first and performance second. This is where fiscal space creation becomes crucial. Every year, low priority policies and poor performing policies are subject to review and can be cut if deemed appropriate. For example, a good policy badly implemented can either be fixed or terminated, but performance and policy-based budgeting will ensure that something is done.

Reformers should not underestimate local capacity to implement Performance and Policy-Based Budgeting.

Due to the failures of budget reforms involving Medium-Term Expenditure Frameworks (MTEFs), there is belief in certain circles that Performance and Policy-Based Budgeting might be too difficult for developing countries. Experience has revealed, however, that failures to move to more accountable and transparent forms of budgeting can be due primarily to resistance from vested interests that have a significant stake in the current way of budgeting. Moving from Auction-Based Budgeting to Performance and Policy-Based Budgeting, for example, is difficult not because budget officials do not have enough capacity to follow a new process, but rather because the political and communications strategy required to make the move successfully, failed or was not properly thought through.

HOW DO WE SPOT A FAKE?

So, in summary, to spot a fake performance and policy-based budget, we should look out for a some of red flags that have been raised above:

Policy Based Budgeting Red Flags

- 1. No medium-term perspective** – only an annual budget is provided with only a single year looking into the future or implausible medium-term fiscal aggregates such as estimates for revenue, expenditure, and fiscal balance.
- 2. No rolling forward estimates** – the budget year baselines for appropriations are not set by the rolling over of the previous year's first forward year.
- 3. Macro-fiscal models are being used outside the resource allocation process** – macro-fiscal parameters are not actually being used in the budget formulation, and fiscal forecasts that are produced do not align with budget allocations at either economic or administrative classifications.
- 4. No explanation of the changes in the budget and fiscal strategy from the previous year** - changes due to parameters, estimates variations, and new policies are not disclosed or are unclear.
- 5. No high-level debate on fiscal space creation and filing** – ministers are not briefed on the room to adjust fiscal policy, and there is limited debate on the best ways to fill the fiscal space.

Performance-Based Budgeting Red Flags

- 6. No reporting by standard functions of government** – there is no reporting on spending by the international standard for the Classification of the Functions of Government (COFOG).
- 7. Annual reports are not easily comparable to the budget** – the same financial and non-financial performance tables that are used in the budget papers must be used in the annual report of performance.
- 8. No reliable reporting of performance targets** – there is an absence of baseline historical performance data, and/or when actual performance data is reported it is not believable. Existing statistical systems of agencies

should be audited for reliability every few years. If not, then those statistics are unlikely to be reliable.

- 9. Performance targets are not actually used to manage performance** – reporting on performance targets can become a compliance exercise rather than a real part of the performance management cycle.
- 10. Lack of linkages between agency-level performance targets and the data monitored by the central budget office** – performance information is not used by the central budget teams responsible for preparing and implementing the budget. Performance indicators also need to be meaningful for the teams responsible for implementing them. With team-based performance management, there should be a clear link between agency and team targets.

Institutional Culture Red Flags

- 11. The administrative culture does not focus on performance** – in getting the basics right, the very first of the “basics first” principles was to “foster an environment that supports and demands performance.”
- 12. There is no aggregate fiscal discipline** – it can be demonstrated that there are implausible estimates of fiscal aggregate figures (revenue, expenditure, and fiscal balance) over the medium term.

The above can be thought of as the dozen tests for fakes and smoke and mirrors in the performance and policy based-budgeting space. That said, not having any of these present does not necessarily mean that the system is not working. What it does mean, however, is that reform efforts are needed to improve the system. By attending to the red flags, a performance and policy-based budget can work as intended. It becomes a very powerful tool, especially in the right hands, to ensure money is raised and spent efficiently and fairly. In the wrong hands, this system of budgeting, if kept in place, acts as a strong set of checks and balances.

While performance and policy-based budgeting is best practice, it still relies on the human factor. Without a professional civil service at the center of government, this system of budgeting can still fail to deliver efficient and effective government and sustainable government finances.

However, with a competent and well-meaning civil service at the center of the government, performance and policy-based budgeting is the very best method for ensuring that government is open, accountable, and is delivering increasingly efficient and effective services to the people in an inclusive and sustainable way.