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What is *Public Expenditure Management* (PEM)?

Is Public Expenditure Management (PEM) just another term for budgeting in the public sector? Not so. PEM differs from conventional budgeting (CB) in a number of ways. First, PEM focuses on outcomes and sees expenditures as a means to produce outputs which are needed to achieve desired outcomes. CB on the other hand focuses narrowly on expenditures on inputs. It preoccupies government agencies with minute details of line item expenditures with only tangential regard for the actual outcomes that budgets are supposed to promote and support.

Secondly, in emphasizing outcomes, PEM highlights the importance of having the right processes, i.e. those that lead to desired outcomes. CB is "legalistic" in its approach. It seeks to ascertain that agency budgets have been prepared and implemented in accordance with prescribed rules and procedures. From this perspective, a good budget is one which follows rules and procedures accordingly. In contrast, in PEM, a good budget is one that produces outputs that lead to improvements in desired outcomes. If the proper implementation of rules and procedures leads to bad outcomes then from a PEM perspective, the rules and procedures are considered flawed and should be reformed.

Third, under PEM, a balance is struck between the *autonomy/flexibility* that must necessarily be given to line agencies for them to produce the outputs needed to achieve the desired outcomes and the corresponding *accountability* of the agencies for producing those outputs. Under CB, discussions between the budget agency (which in most countries is the Ministry of Finance) and the line agencies focus on the allocation of budgets to line (input) items and correspondingly limits the accountability of agencies to the proper disposition of funds in accordance with the agreed upon allocations. Consequently, the accountability of line agencies is diluted. Even if a line agency fails to meet its mandate, provided it stuck to the agreed upon allocations, it is generally not held accountable for the failure.

1. The Three Level Outcomes

Public expenditure management (PEM) is an approach to public sector budgeting that is oriented towards achieving socially desired outcomes. In particular, PEM asks the following question. What outcomes do we want to achieve through the budget and what procedures, rules, and processes do we need to put in place in order to achieve these outcomes?

In general, PEM tends to promote the achievement of three outcomes, namely, aggregate fiscal discipline, allocative efficiency, and operational efficiency. *Aggregate fiscal discipline* refers to the alignment of public expenditures with total revenues (domestic revenues plus a sustainable level of foreign borrowing); roughly speaking, it means keeping government spending within sustainable limits. In layman's terms, it means don't spend more than what you can afford. *Allocative efficiency* on the other hand refers to the consonance of budgetary allocations with strategic priorities: are budgetary resources being allocated to programs and activities that promote the strategic priorities of the country? Put simply, is the government spending money on the "right" things? And finally, *operational efficiency* refers to the provision of public services at a reasonable quality and cost. The relevant question here is whether the country is getting the best buy for its money.

The achievement of these outcomes is plagued by complex, underlying problems. That is why public sector budgeting is perhaps the most challenging routine task for any government.

2. Aggregate Fiscal Discipline and the Tragedy of the Commons

Instilling aggregate fiscal discipline is not as simple as it sounds. There is a fundamental problem that makes it difficult to achieve. That problem is what economists refer to as the "tragedy of the commons" or the common pool problem.

Imagine a small fishing village with 10 families. Everyday, the head of each family goes out to catch fish in the river. As far as (s)he is concerned, the *fish is free*. The only cost to him are the depreciation on his boat and fishing equipment, fuel, food for the day, and perhaps some bait for the fish. Now, people have a natural tendency to get as much as they can of anything that is of value *that is given for free*. Hence, a fisherman will have a tendency to catch as much fish as possible until (s)he tires out. All ten of the fishermen will thus tend to "over-fish." For as long as there are only 10 families, this should not pose much of a problem. But suppose now that over time the number of families increases to 100. Suppose further that they each "modernize" by adopting dyna-

mite fishing "technology." Then quite clearly in due time the fish will disappear since the rate of fishing will far surpass the natural rate of reproduction. The village eventually becomes impoverished.

The annual budget is somewhat like the common pool of fish in the river. Each claimant to the budget considers the budget as a "free" resource since his or her demand is such a small proportion of the total budget and therefore will not impose much of a loss to the total. But, of course, if every claimant behaved this way, the aggregate of their demands will far exceed what is available. Hence, absent any constraint, meeting the demands of disparate claimants to the budget is likely to result in large, unsustainable deficits that translate into an unstable macroeconomic environment — high inflation, high interest rates, burgeoning current account deficits – all of which will necessarily retard economic growth and efforts to reduce poverty.

3. Allocative Efficiency, Preference Revelation, and Cost Revelation

Assuming aggregate fiscal discipline can be instilled, there is a second major challenge which confronts any government. How should the constrained budget be allocated?

Technically this involves making calculations at the margin so that "the last dollar spent on each program yields the same net benefit to society." More simply, it means the government spends the money on the "right" things. But what is "right" depends on (a) the priorities of society and (b) the cost of programs and activities needed to meet those priorities. A program may be relatively inexpensive but does not fall in any priority area. Or, a program may be in a priority area but cost a lot more than another program in some other priority area. In either case, the program is "not right."

To establish priorities, one needs to know the preferences of the citizenry. But this we know is a difficult task. Economists refer to this as the problem of preference revelation. Some mechanism to get citizens to reveal their true preferences has to be developed. Even though in practice, such a mechanism will never be perfect and in all likelihood will be highly imperfect.

Obtaining the cost of programs is an equally difficult task. In practice, line agencies and in some cases local governments are in the best position to know what the real cost of programs are since they are the ones who formulate and implement them. But line agencies have very strong incentives to withhold this information from the budget agency. For instance, it is common practice for a line agency to use the "toehold" approach for large programs/activities. In order to get easy approval from the Budget agency, a line agency will first submit a low cost estimate for the program. Not knowing any better, the Budget agency approves it since it is relatively low. Having gotten a "line item" in the budget, the line agency then seeks additional funding the next year and the next etc.. In short, the true cost of the program may have been $100M but, to get the program through, the line agency claims (in the first year) that it will only cost $ 10M. Once a "property right has been secured", it knows it will be easier to get the rest of the funds.

4. Operational Efficiency, Monopoly, and the Principal Agent Problem

Suppose that the government manages to instill aggregate fiscal discipline and to enhance allocative efficiency. That is, it stays within its budget and spends on the right things. It still has to confront the challenge of providing services at an acceptable level of quality and at reasonable cost?

In this case, there are two problems. The first is the inevitability of government being the monopoly supplier of some, in fact many, services. A monopolist has little incentive to keep costs down and provide good service. Government as monopolist is no exception. In the case of obtaining a driver's license, for instance, because a citizen has no choice but to get it from the drivers license bureau, the service is usually grossly inefficient (and invariably corrupted).

The second is a typical management problem. How can top management monitor the performance of the company staff? Top management has a set of preferences and priorities which it seeks to satisfy. Staff may not necessarily have the same preferences nor share the same priorities. When such misalignment occurs then there will be a tendency for some staff to try and "shirk", i.e. do other than what management wants them to do. This is what economists refer to as the principal agent problem. It is particularly severe in government because the likelihood of misalignment is much higher.

The more severe the misalignment, the higher will be the cost of monitoring the performance of staff. And the higher the cost of monitoring, the less monitoring there will be. Consequently, inefficiencies will creep in. It is no wonder for instance that, in many developing countries, considerable corruption occurs in the public procurement of goods and services. While such problems occur in private firms, competition and the profit motive tends to limit it. Unfortunately, in the public sector, monopoly is the more general rule and there is no "bottom line" profit to contend with.

5. Institutional Arrangements and Incentives

The problems that underpin public expenditure management have been analyzed from the perspective of the new institutional economics (NIE). And this has resulted in a number of innovative recommendations.

The NIE basically takes typical microeconomic concepts and theories and applies them to an analysis of institutional arrangements. Institutional arrangements include norms, rules, procedures, and the like, both formal and informal. An institution embodies a set of institutional arrangements. For example, voting rules in Congress (e.g., closed rule, majority rule) are institutional arrangements. Congress on the other hand is an institution; it is governed by numerous in-

stitutional arrangements. In the same way, the Presidency is an institution; the veto power of the President on the other hand is an institutional arrangement.

Aggregate Fiscal Discipline

A common pool resource such as the fish in the river has the problematic property of being "free" though it is of some value to people. The trick here is to find an institutional arrangement that introduces a cost or price to the resource that is commensurate to its value. In the case of the annual budget, what has proven effective is the imposition of a credible hard budget constraint – total spending during the year cannot exceed a pre-determined, immovable amount. What this does is it forces claimants to the budget to make trade–offs. Building a bridge costing x dollars means giving up some other project costing x dollars. That is, a hard budget constraint effectively introduces an implicit price to any program or activity (economists call this the opportunity cost of the program or project). A claimant knows that (s)he will not be able to get all he or she wants since anything (s)he claims will take something away from someone else and that someone else is bound to complain and could block his or her claim, i.e. there is a price to get the things (s)he wants. Claimants thus make trade-offs among the various programs that they want funded — they prioritize. Consequently, the resulting claims on the budget tend to be more rational or reasonable. And, they do not burst the budget.

Sweden has an interesting arrangement that sets credible budget ceilings. There, the law was amended so that the legislature would have to vote on the budget in two stages. In the first stage, it decides, i.e. votes, on the aggregate level of spending and the allocations of that aggregate to different sectors, e.g. health. The resulting figures then become law: neither the legislature nor the executive can fiddle around with the aggregate and sectoral expenditure levels. After this initial vote, the line ministries prepare the details of their budgets and each knows that they cannot exceed the level set by law for their sector. Their proposals are submitted to and discussed with the Budget agency which then submits a final overall proposal to the legislature. The legislature then proceeds with the second stage of voting on the budget. At this point, it can no longer question or change the aggregate and sectoral ceilings though it could do so for items within the proposed budgets of each agency.

Allocative Efficiency

Preference revelation is a very difficult problem to address. Many economists have written treatises on this and the results have been nothing short of complex (and sometimes confusing). Yet, the problem has to be addressed if the budget is to be allocated efficiently across sectors and, within sectors, across programs and activities. One way this is handled, albeit very imperfectly, is through a bottom up process of preparing a medium term development plan.

In a number of countries, the national government begins the planning process with extensive consultations with different stakeholders – the regions and districts within those regions, sectoral interest groups, business associations, labor unions, etc.. The resulting development plan incorporates to the extent possible the broad priorities enunciated by stakeholders (which reflects their preferences). For example, it could include improving the standard of living of the poor through population planning where the latter encourages the use of contraception but not abortion. This process tends to be time consuming but it results in priorities that majority of the people will accept and support – it becomes *their* plan. As a consequence, it gives the government a barometer of what programs and activities are "right".

The problem of cost revelation is just about as complex. This is not surprising because, like preference revelation, it reflects a situation where one party needs important information to make a decision but that information resides in someone else's head. In the case of budgeting, the budget agency needs to know how much each program costs. However, not having first hand experience with the programs, it has to rely on line agencies for this information. But, as mentioned earlier, a line agency has very strong incentives not to give the Budget agency this information – of course, it wants to get as much from the budget.

A Medium Term Expenditure Framework (MTEF) helps alleviate this problem. In the next issue, the MTEF will be discussed in detail. For the moment, suffice it to say that it embodies arrangements that require line agencies to cost out more accurately their programs over the medium term, normally over three to four years. This arrangement forces line agencies to reveal more of the true costs of their programs. In the example above, the agency can no longer say that its proposed program will cost only $10M. At the very least, it would have to say it cost $30M over three years. While not quite accurate, it still comes closer to the real cost of $100M.

Operational Efficiency

The principal agent problem is another one of those issues which economists have beaten to death. For instance, a considerable literature exists on the appropriate contractual arrangements between a landlord (the principal) and a tenant farmer (the agent). In the context of operational efficiency, the oversight agencies (including primarily the budget agency) are the "principal" and each line agency an "agent". Moreover, within a line agency, the minister is the principal and his management staff the agents. Within a division in the ministry, the manager of the division is the principal and the staff are the agents. In short, there are several layers of principal-agent relationships. Is it no wonder then why many governments tend to be (operationally) inefficient.

In the private sector, this problem is also endemic. But CEOs and managers in the private sector have a very important ally – profits, competition, and the market. The bottom line is something that managers can easily monitor. So by structuring the company so that sources of profits (and losses)

are easily discernible, management can more easily identify who is to blame or reward. Staff, particularly those in the line departments, cannot manipulate the market. People buy a product because they want them and/or they get good service. Hence, if a product's sales decline then the manager of the division for that product line is to blame. Within the division, the manager will also know which of his line people has performed poorly since the division will likely be structured into sales districts with division staff assigned to each of those districts.

One implication of this is that, to the extent possible, government should use the private sector to help deliver services since it is better able to address the principal agent problem. Some services can be privatized or outsourced; for others, the management can be contracted out. And, if using private firms is not possible (perhaps due to legal constraints) then benchmarking public sector delivery with similar services delivered by the private sector could be considered.

If the private sector could deliver all public services then our worries would be more easily manageable. Unfortunately, many government services still have to be delivered solely by government (especially in the rural areas). For such services, one faces a double whammy – the principal agent problem and monopoly.

The institutional arrangements that help address the two problems fall into two categories. The first category deals with the incentive structure embodied in civil service rules, norms, and regulations; the second pertains to procurement rules, regulations, and procedures. Both will be discussed in subsequent issues.

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References for Further Reading:

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The Editor's Corner

Welcome to the maiden issue of *The Governance Brief*. We have introduced the GB to respond to inquiries and demands for short, easy to read references on specific governance related issues. While there is considerable literature on governance issues, much of it is too specialized, technical, and/or extensive for the typical interested reader. We hope the GB will meet the latent need for informative quick read pieces. Each issue can be easily filed for quick referral. And each includes references for those interested in reading more about an issue. Enjoy the journey through the governance landscape.

Forthcoming Issues:

The Medium Term Expenditure Framework (MTEF)

Understanding Public Procurement

ADB Staff are encouraged to contribute to The Governance Brief. Contributions from external parties will also be considered. For details, kindly contact: Merly Mallion at 632-6561 or via email at mmallion@adb.org.