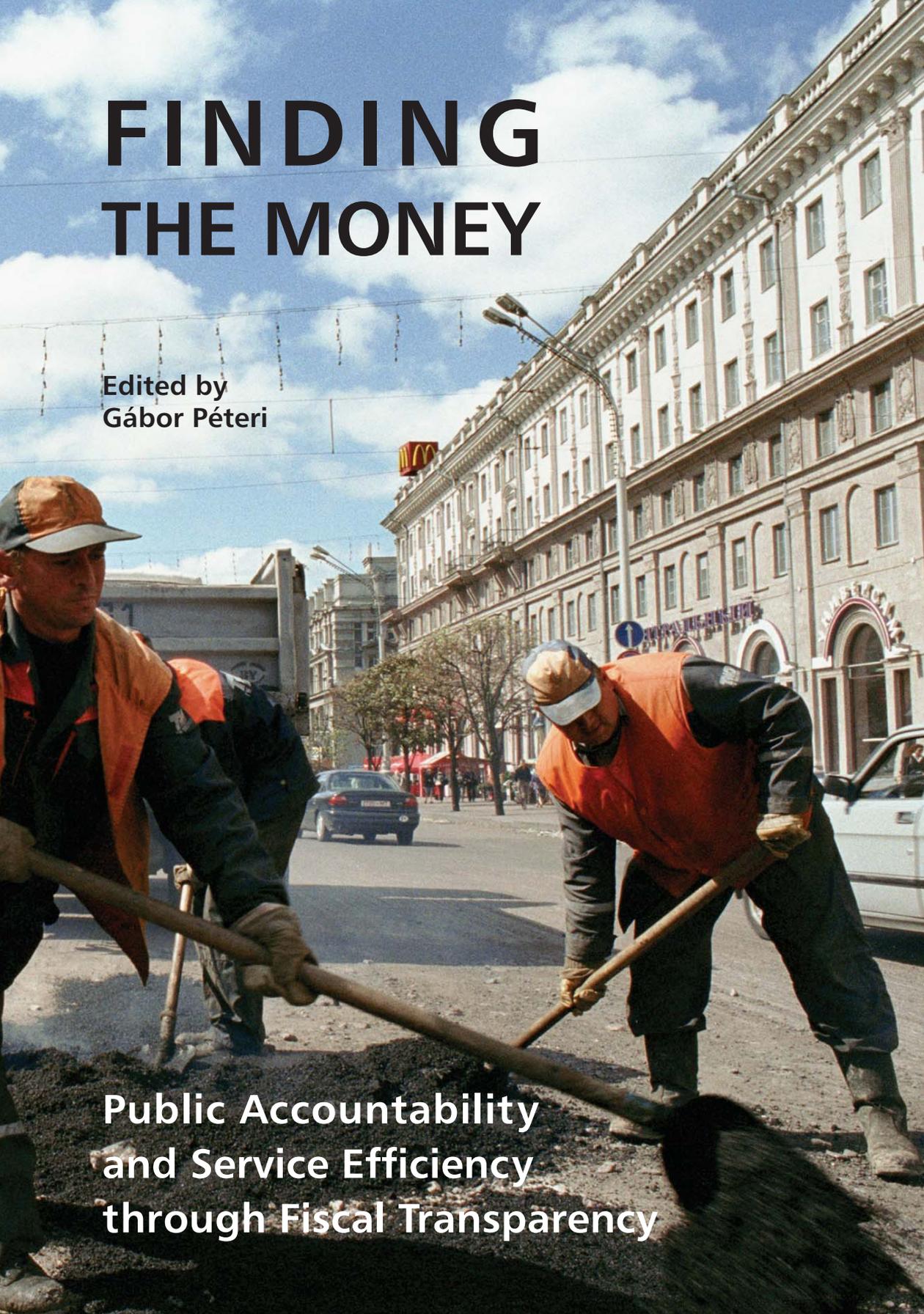


FINDING THE MONEY



Edited by
Gábor Péteri

Public Accountability
and Service Efficiency
through Fiscal Transparency

Finding the Money

*Public Accountability and
Service Efficiency through Fiscal Transparency*

Edited by

GÁBOR PÉTERI



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and Public Service
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I would like to thank the authors, who as leading experts in their fields, contributed to this volume. I would also like to extend my thanks to the organizers of the Central European University Summer University office; the course conveners Fredrik Galtung, Viola Zentai, and Ágnes Batory; the Center for Policy Studies' staff, especially Lilla Jakobs and Sabine Roser who helped the project to completion; and the SUN 2007 participants who contributed their engaging ideas during the course.

Gábor Péteri

Editor

Executive Director, LGI Development Ltd.

February 2008

Foreword

The materials gathered for this publication are part of a larger initiative of the Center for Policy Studies at CEU and *tiri*—MAKING INTEGRITY WORK, a London-based NGO. In order to address broader issues of governance reform, public policy dilemmas, and democracy building challenges, the Public Integrity Education Network (PIEN) was launched jointly by *tiri* and CPS in 2004 and has been lead by *tiri* since 2006. The network was established with the following key objectives: to facilitate the development of effective, policy-oriented training and teaching programs on corruption control and organizational integrity; to bring together established, leading universities primarily from major regions of the world so that new training practices can enter into the mainstream and rapidly gain local legitimacy; and to build regional networks for joint research projects and the development of a pool of critical and independent case studies of reforms.

One of the key activities of PIEN in the last three years has been the development of a flagship advanced summer course on Integrity Reform, within the Central European University's Summer University setting in Budapest. Drawing on interdisciplinary academic perspectives and lessons learned from practice, this course represents one of the few targeted, applied, and yet conceptually grounded efforts currently available internationally for the analysis of corruption and anti-corruption. The 2007 summer university succeeded in bringing together a critical mass of individuals involved in this topic of high policy and social relevance. A novelty in 2007 was the division of the course into four Policy Labs devoted to the in-depth analysis of (a) *Applied Legal Skills for Integrity Reform and Anti-Corruption*; (b) *Fiscal Transparency and Corruption Risks*; (c) *Governance of Natural Resource Revenues*; and (d) *Integrity in Reconstruction Aid and Programming*.

The overarching aim of the policy labs was to bring together international experts in a given field and experienced stakeholder representatives to identify and address the key policy challenges faced in a particular domain. By providing sufficient coverage of the analytical, methodological, and strategic issues faced in a number of different contexts, credible strategic policy reviews were developed. Lab participants revealed a coherent structure and set of learning outcomes that can be used as the basis of teaching in mainstream education. The policy labs were devised as a problem-centered collaborative effort that called for innovation, experimentation, and testing based on empirical evidence.

The development of the Policy Lab on *Fiscal Transparency and Corruption Risks* was a joint endeavor between OSI's Local Government and Public Service Reform Initiative (LGI), the Center for Policy Studies at CEU, and tiri—MAKING INTEGRITY WORK. The objective of this lab was to combine a civil society agenda, focusing on transparency and accountability, with a governmental perspective in terms of corruption risks in public finances, budgeting, and financial management. The multidisciplinary approach involved insights from public finance, public policymaking, and various fields of public service management. The lab was grounded in two distinct but complementary perspectives on public finance: one arising from the fiduciary duties of governmental agencies, the other from demands of opening up budgeting and financial management to wider social control—both of which imply increased attention to minimizing the loss of public money to corruption and incompetence.

The contributions to this resource book by the invited experts, of whom many served as resource persons to the course in 2007, will demonstrate our strong conviction in an approach that tackles technical governance and broader accountability problems in their interrelations. We hope that this volume will provide a useful tool to those who are committed to working towards making government institutions more open and decision-making more inclusive. We are confident that there are many such committed practitioners, advisers, and civil society activists working with governments both on the national and sub-national levels for the benefit of the broader public.

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Introduction: Fiscal Transparency
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1. Corruption Is Systemic

Corruption—the use of public power for personal gain—has been studied from many different angles. The chapters collected in this publication mostly focus on one aspect of corruption, when decisions are directly linked to public finances. So regardless of the fact whether corruption provides personal or institutional gains, whether it is considered grand or petty, these reports examine different stages of public finance management. They analyze the budget cycle starting from the allocation of public funds (budgeting), through revenue policies (tax collection and the sharing or transferring of national budget funds to lower levels of government) and spending (procurement, contracting, asset utilization) till audit and its information base.

The most effective anti-corruption policies can be designed by understanding governments' incentives and their behavior in those areas *where the money is*. Our assumption is that the risk of corruption is the highest in those fields and transactions where money directly flows between different actors. Mismanagement of public funds does not always mean that personal benefit and misuse of public resources is always intentional on every occasion. These are just the areas that are most frequently exposed to corruption and inefficiency, and a better understanding of the rules of the game will lead to greater integrity and better service provision in the public sector.

This approach, focusing on *malfunctioning government* is based on the assumption that corruption has systemic causes. Consequently, the problems of low-scale bribes or grand corruption should be understood within the broader framework of public sector rules and procedures. Unprofessional government decisions and inefficient management of services will lead to accidental losses in the public sector. So behind corrupt government practices one could often find a lack of knowledge, missing competencies, and a low level of technical capacities.

The basic requirements of fiscal transparency—set by the International Monetary Fund—also identify four major systemic areas of good government. They are the clarity of roles and responsibilities; the availability of public information; open budgeting and reporting; and the assurance of integrity through consistent, relevant, and audited data.¹ So governance matters a lot in the fight against corruption.

2. Governance Matters

The term governance in this context is used in a broad sense. Firstly, governance aims to ensure *legitimacy* through better accountability. It is achieved through representation and due processes, but legitimacy is also based on trust. The political practices and administrative institutions have to be adjusted to the given social environment and they should be commonly accepted. Secondly, governance is about the capacity of

professional *decision-making*, which is supposed to be transparent and inclusive as well. Thirdly, good governance means also the policy *implementation* capacity. This aspect of governance is highly relevant in the period of expanding markets and when government functions are changing under New Public Management schemes.

These three dimensions of governance show that corruption is affected by several factors. Consequently, anti-corruption policies might have different forms, ranging from legal and administrative measures to the opening of decision-making procedures and increased professionalism in public service management. Proportions and timing of these techniques will influence the success of anti-corruption measures.

2.1 Decentralization and Corruption

The form and scale of decentralization are critical elements of government modernization efforts. With expanding municipal functions and competencies, the lower government levels have high responsibilities in managing public functions.² So in countries with multi-level governments—being federal states or unitary countries with diverse municipal structures—various issues of corruption come up. The basic questions are whether corruption is higher in more decentralized states and are specific accountability schemes and integrity mechanisms needed at different levels of government.

Despite the skepticism of general public opinion towards the impact of decentralization on corruption (“like the sea, the deeper we go the darker it is”), the literature does not prove that corruption risks become higher with decentralization.³ The primary lesson from these studies is that the level of corruption depends on *how* decentralization was implemented, and consequently on the interacting social, administrative, and financial factors. So integrity mechanisms will be different in developing, transition, and developed countries.

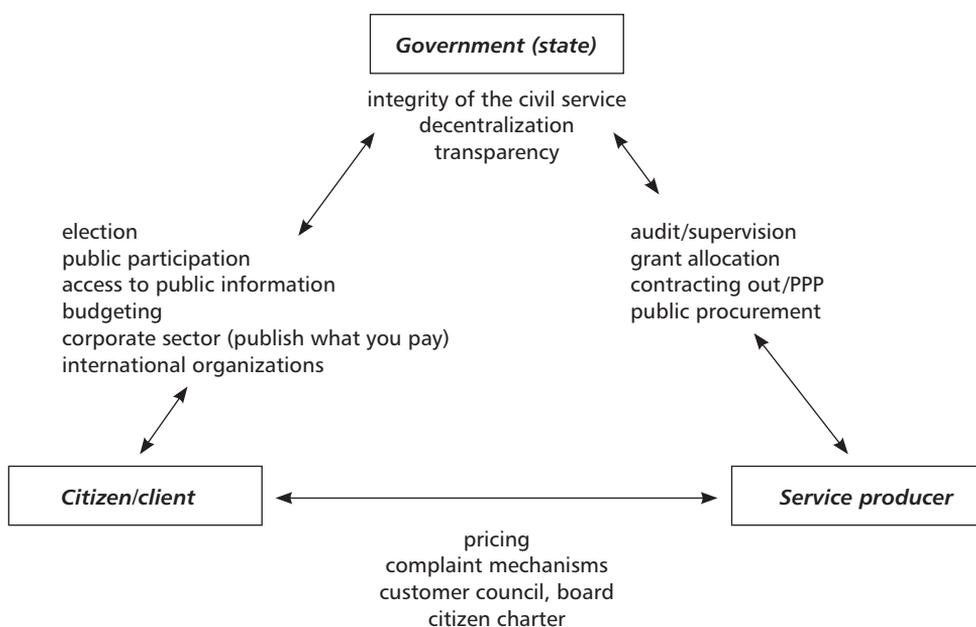
In a decentralized setting great efforts have been made to understand the role of local governments in public sector integrity. And the increased number of corruption cases may be explained by the new ease with which they can become public. In developing countries decentralization did not necessarily bring the intended results of greater accountability and transparency, as family-based social networks captured local leadership and created uncontrolled lines of reciprocity. But the experiences of successful transition countries have proved that fiscal (revenue) decentralization increased local accountability and created incentives for innovations and increased transparency.

3. The Accountability Framework

The methods and techniques of accountability are critical conditions of successful anti-corruption policies. Within public service provision, where fiscal transparency issues most often come up, accountability schemes are built around three actors and in several directions.⁴ The World Development Report in 2004 has widely publicized this model by specifying the linkages between the main actors in service provision: (i) citizens/clients, (ii) government (state), and (iii) the service producer. Based on this approach, the long and the short routes of accountability have been identified by separating vertical (citizen-government; state-contractor) and horizontal (client-service producer) connections (Figure 1).

This categorization of instruments of public sector accountability has not only helped to develop new tools, but it also has supported their effective use for different types of public services. So the “*voice*” mechanisms of public participation, better access to information, and open budgeting put a greater pressure on governments in the case of services with larger economies of scale (e.g., water supply) or low-income barriers (e.g., urban transport).

Figure 1.
Improving Social Accountability in Public Service Delivery



The horizontal linkage between the user of public services and the service organization is based on various instruments of control. This short route of accountability is primarily based on “*exit*” mechanisms offered by the marketization of public services. In this case user charges and fees provide direct connections between the customer and service producer. Pricing is supplemented by other forms of influence through complaint mechanisms, general contracts in the form of citizen charters, and control over management decision in consumers’ councils.

The long route of accountability—the linkage between the citizen and service producers through the state—is completed by the “*compact*” mechanisms introduced by the government. They are various forms of technical supervision, the audit system, and financial transfer schemes. In a market environment rules and procedures of cooperation between the public and private sector supplement these traditional forms of control. Public procurement and contracting out regulations, and legal and financial conditions of public-private partnership schemes determine the balance of power between government, citizens, and contractors.

Chapters in this book discuss some of these techniques of accountability and their impact on public sector integrity. However, all these methods are developed in a specific social and economic environment, so the country context of corruption has to be taken into consideration.

4. Context in the Corruption Formula

The classic formula on corruption incorporates three factors that determine the level of corruption: monopoly power, discretionary authority, and level of accountability. Obviously, the lack of competitors will increase the risk of corruption, as there are no alternatives. Within this monopolistic environment (in the arms business, oil industry, public works, etc.), where decisions are usually not controlled by any balancing market powers and there is a wide discretion over any kind of resources, the chances of corruption are higher. Unless some forms of accountability limit the discretionary powers.

However, this model with the three factors is always influenced by the social environment. Corruption means different things in different societies and the level of tolerance greatly varies by cultures. This is why the ethical system is built into the original model by “putting into brackets” **m**onopoly, **d**iscretion, and **a**ccountability: $C = \{m+d-a\}/e$. Due to differences in values and social norms, acceptance of corruption greatly varies in different cultures. These country-specific factors are expressed by tolerance of society towards corruption and they are also reflected by the administrative culture or civil service ethics as well.

Researches based on world values surveys have proved that *cultural factors explain 75 percent* of the variation in the perceived corruption index.⁵ Along the economic

dimension of values, the “survival” orientation defines higher levels of corruption, while on the social axis it is “traditional” values. This is known from everyday practice: the transparency of public decisions is limited when a shortage of goods and services increases the risk of corruption or when family lines determine social interaction.

Strong local networks, often closed societies with tribal or family-based cultures, might create an environment where corruption is tolerated. This social capital can be utilized successfully by some individuals; however, the larger community suffers significant losses. But these values are going through a *change over time*, when new generations become better educated and wealthier.⁶ This will result in more rational argumentation-based decision-making in the public sphere and the gradual dominance of self-expression values will promote the opening up of the public sector.

5. What to Do?

The great variety of relationships between the critical actors in different cultures will make the choice of effective anti-corruption methods more complicated. There is a wide range of potential actions: economic measures, legal and administrative methods, rules and procedures, and the involvement of other social actors.⁷ This complexity explains why the exchange of experiences in the fight against corruption is managed at two different levels: on the one hand, there are general international codes and conventions and, on the other hand, toolkits and case studies are compiled on specific subject areas. Their objective is similar, as both of them intend to provide assistance to governments, civil society organizations, or businesses to develop their own methods for coping with corruption.

This book intends to combine the lessons from the general recommendations and the instruments used for specific areas in the public sector. There are three basic messages, which are put into the overall framework of good governance.

5.1 Risk Assessment Approach

As there are several factors influencing the quality of governance, the scope of actions in fiscal transparency has to be limited. In order to narrow down this broad topic, the risk assessment approach was followed in the selection of the key issues of corruption in public finances and public service management. We tried to identify those topics and sub-areas of governance that are the most exposed to corruption. This risk assessment method—often used in auditing—might be helpful in developing anti-corruption policies in specific areas as well.

5.2 Cut the Web

In more complicated cases, like public procurement or contracting with private service providers when social traditions also influence these transactions, anti-corruption policies have to take into account the complexity of these interactions. The simple two-level, principal-agent model with a vertical relationship has to be further refined. Corruption exists within the public sector between various public agencies and actors who issue licenses, deal with environmental problems, etc. Under this scheme, a principal itself becomes a client, who might reach another principal through an agent. So this relationship could be characterized more as a web of informal connections within the public sector, having contacts at certain points with private entities.

International organizations, as financial institutions or through their technical assistance programs, are also involved in these public service actions. In this sense accountability became global, so actors can move out from the domestic arena and influence local actors through international organizations. This has modified the accountability scene and opened new possibilities for cutting the informal network of interconnected actors in the domestic scene.

5.3 Transparency Does Not Solve Everything

An important lesson from using the governance approach was that corruption in public finances can be decreased principally in two ways. Firstly, by making government institutions more open and decision-making more inclusive. This is true in the case of budgeting, contracting out, and management of public assets. But there are areas of government operation that cannot be made entirely opened. Either because the technical complexity of the issues (e.g., details of public procurement, monetary policy) or because of the confidential nature of the government action (e.g., protection of personal information by the tax administration). So the lesson is that in these cases when decisions cannot be made entirely transparent, then internal mechanisms and procedures of the public institutions should be improved. Here administrative accountability, rules and regulations of public sector management, and the enforcement of ethical standards might be the solution.

6. Chapters in This Book

The topics of this book are connected to each other under the good governance and accountability framework. After presenting this new accountability agenda, the specific anti-corruption approaches and measures are discussed in the following chapters of two types. The first ones focus on the integrity mechanisms of the public (civil) service,

intergovernmental fiscal relations, tax administration, and audit and supporting fiscal information systems. These are the topics where public institutions and decision-making procedures can be controlled by the general public indirectly. So here transparency should be *combined* with administrative accountability mechanisms.

The second group of topics on the rules and techniques of budgeting, forms of public-private partnerships, and public asset management is more about those issues, where transparency and *direct involvement* of the public is feasible and desirable. They are the tangible issues where public actions are exposed to corruption, because this is “where the money is.”

These two types of topics are put into the cycle of public fund management. But we could not cover all the issues of fiscal transparency and corruption control in the good governance framework. The most important subject areas left out from this book are planning rules, administrative regulations on issuing permits and licensing, procedures of urban planning, preparation of government decisions, and public policymaking.

As the summer university course in 2007 also focused on other critical areas of public integrity (postwar reconstruction, management of natural resources), the linkages to these specific topics have to be further explored as well. In transition countries a similar cross-cutting theme left for future analysis is corruption in multiethnic countries and communities.

These papers targeted towards two groups of potential readers. Firstly, they were aimed for the participants of “Integrity Reform and Strategic Corruption Control” at the Summer University Course at Central European University in 2007. Hopefully the participants of future SUN courses will find them useful. Secondly, the publication is intended to help the Local Government and Public Service Reform Initiative of Open Society Institute–Budapest in designing their programs and also in assisting its partners.

Notes

¹ IMF. 2001. *Manual on Fiscal Transparency*. FAD/IMF, Washington, D.C..

² For example, in Hungary 45 percent of public purchases are implemented at the local level, so 23 percent of their total value is in under local government control (Kósa, E. and N. Alexa (eds). 2007. *Corruption Risks in Hungary. National Integrity System Country Study*. Transparency International; Budapest).

³ Fjledstadt, O-H. 2004. “Decentralisation and Corruption. A Review of the Literature.” CMI Working Papers 10. Bergen, Norway: Chr. Michelsen Institute; Cavill, S. and M. Sohail. 2007. “Accountability Arrangements to Combat Corruption. Literature Review.” Loughborough University, Loughborough, UK: WEDC.

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Good Governance and the Emergence of a New Accountability Agenda

Serdar Yilmaz and Yakup Beris

Disclaimer

The findings, interpretations, and conclusions are entirely those of authors, and do not represent the views of the World Bank, its executive directors, or the countries they represent.

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Abstract

This chapter discusses the evolution of the elusive concept of accountability. It first tries to elaborate on the kinds of relations that constitute accountability. It also presents the components, directions, and dimensions of accountability to better discern the different meanings of the concept often used confusingly in the literature. The chapter then discusses different approaches that are used to strengthen accountability relationships both within the public sector and between the public sector and citizens. In order to do so, the chapter groups these different approaches under two main categories: supply- and demand-side accountability approaches. The goal is to present these often loosely connected approaches in a coherent framework that recognizes the interactions among them which target improving the accountability of both central and local governments towards citizens. The chapter builds on the interrelationships between the concepts of the discretion and accountability and it argues that accountability follows discretion granted to public officials. The argument is such that elected and appointed officials in central and local governments should be provided with an appropriate discretionary space, the use of which would be the source of their accountability. The accountable use of their discretion could be facilitated both by public sector and social accountability approaches that aim to strengthen citizen oversight and vigilance over the political, administrative, and fiscal spheres of such discretion.

1. Accountability: An Elusive Concept

Over the last decade, accountability has come to be recognized as the cornerstone of good governance in development discourse. However, the scope and meaning of accountability has been extended in various directions so much so that it became an elusive concept—it means different things to different people (Mulgan 2000). In a variety of political and academic dialogues, it is used as an umbrella concept, synonymous with transparency, accessibility, responsiveness, answerability, control, responsibility, and integrity. These terms are very important components of accountability; however, they themselves do not constitute a genuine form of accountability (see the section below on components of accountability).

In discussions on good governance, it is also very important to cover the issues of the direction and dimensions of accountability. There seems to be a plethora of terms used in the literature. Each implies a different *direction* and *dimension* of an accountability relationship.

1.1 What Exactly Is Meant by Accountability?

In political discourse accountability often is used interchangeably with good governance, which stretches its meaning further, contributing to its elusiveness. Accountability actually specifically refers to the practice of account giving. The most concise description of accountability is the obligation to explain and justify conduct (Bovens 2006). It therefore is also a social relationship between an actor, the accountant, and a forum, the account-holder or accountee (Politt 2003). According to Bovens (2006), the accountability relationship between the actor and the forum consists of three elements: (i) the obligation of the actor to inform the forum about his conduct; (ii) the forum's power to interrogate the actor and to question the adequacy of the information or the legitimacy of the conduct; (iii) the forum's power to pass judgment on the conduct of the actor—it may approve of an annual account, denounce a policy, or publicly condemn the behavior of the actor.

1.2 What Are the Different Components of Accountability?

An accountability relationship as such between an actor and a forum is composed of various constitutive elements. It is important to note here that these elements individually are necessary but not sufficient conditions for a relationship to be an accountability relationship. Presenting them individually as if they constitute accountability relation-

ships is a major source of confusion in the accountability literature. The constitutive elements of accountability include:

- *transparency*, being exposed to public scrutiny;
- *accessibility*, to anyone, anytime, anywhere;
- *responsiveness*, to people's needs and preferences;
- *control*, for the abuse and misuse of public authority;
- *responsibility*, of public servants to their professional standards and ethic values;
- *integrity*, that describes high standards for the conduct of work.

Transparency

Transparency is about establishing open processes and providing systematic reports on government operations. Access to information is a precondition for public scrutiny. It is a basic building block for open government and is enshrined in the constitutions of many Western countries.

The publication of annual reports, performance data, and public accounts are important tools for ensuring public scrutiny of past government actions. The publication of policy documents, strategic plans, and legislative timetables are all important features of public sector openness. They should all be done in a way that enables non-public stakeholders to monitor government actions and be able to contribute to policymaking processes and plans for the future.

Yet, it is important to note that while transparency is an important source of accountability, it does not guarantee accountability (which is essentially built on answerability and sanctions based on certain standards).

Accessibility

Building an open government that is accessible to anyone requires, at a minimum, provisions to ensure equal treatment. A freedom of information law is one of the recent public sector tools used in establishing an open government as such. However, as these laws are very recent in historical terms, their impact on accountability has yet to be seen in many developing countries. Administrative laws also can help build more open and accessible governments by defining the basic conditions for citizens' access and establishing mechanisms for holding public institutions accountable for their performance and decisions. They provide guarantees for citizens in their interactions with government, uphold the rule of law, and give substance to constitutional rights. They often include provisions to ensure that citizens who are potentially affected by administrative actions and decisions have the possibility to receive prior notice of, and defend their interest in, a given decision-making process. They offer choice and provide means for seeking redress. Many countries have introduced citizens' charters with the aim of providing

high-quality public services. By introducing these charters, governments have provided citizens with a means of assessing their own experience as users of public services against declared standards of service.

Responsiveness

Responsiveness is the capacity (and willingness) to identify and respond to the needs and preferences of citizens. A recent discussion note prepared for U.K.'s Department for International Development (DFID) addresses the distinguishing aspects of accountability and responsiveness¹ (Moore and Teskey 2006). According to the note, accountability can be a very powerful source of responsiveness but it is not the only source. There can be many other sources of responsiveness, including (a) war or confrontation with radical internal oppositions (the need to keep people loyal and supportive), (b) a strong sense of nationalism, including pride that one's people are doing well compared to others (c) fear that, if the masses are not educated or healthy, the whole nation, including the elite, might suffer, and (d) the desire to help taxpayers prosper so that the government might get its revenue easily (Moore and Teskey 2006). To say that a government is responsive implies nothing about why that is the case. The interesting case the note presents is the governments of the Confucian world (Taiwan, Japan, Korea, China, and Singapore) who could be identified as responsive to mass welfare despite the absence of strong accountability mechanisms (Ibid 2006). The point here is that presence of high level of responsiveness does not guarantee high levels of accountability, and vice versa. In that sense, accountability may or may not bring responsiveness. Similarly, responsiveness, being a kind of behavior, may or may not constitute to form an institutionalized form of account giving against preset standards (accountability). This is why it is important to distinguish between the two and not to fall into the confusion often seen in the literature.

Control

The control component of accountability seeks to ensure that the authoritative and coercive powers of state are not abused or misused. In different systems, an array of accountability processes and mechanisms help to control the exercise of power.

Responsibility

Public servants are accountable to their professional organizations as well as their ethical beliefs for responsible behavior.

Integrity

Public sector activities that have a demonstrable ethical base are an important part of building and maintaining public trust and enabling employees to better serve the public interest. Many governments have agency codes of conduct and ethics as well as principles of conduct in place.

These terms—transparency, accessibility, responsiveness, answerability, control, responsibility, and integrity—are often used as a synonym for accountability. Yet, as mentioned before, although they are very important prerequisites for accountability, they themselves do not constitute a genuine form of accountability.

An accountability relationship is characterized by three building blocks: *standards, rules, and norms* (against which the accountee is measured); *answerability* (the obligation to inform and to explain the conduct against the standards); and *enforcement* (the capacity to impose sanctions on power holders if those standards are not met) (Goetz and Jenkins 2001).

Answerability here refers to the obligation of public office holders to explain and justify their conduct to others. It is about having the obligation to answer questions regarding decisions and actions. Answerability is an important component of accountability, uncovering unauthorized actions by office holders, and allowing for the next step to build an accountability relationship: enforcement.

In the public sector literature on accountability, the aspect of enforcement is very often not an explicit feature of the accountability definition. It is assumed that enforcement forms a natural part of the bureaucratic sanction and reward scheme and accountability is often used as a synonym to responsiveness. With the recognition that good governance cannot be achieved by governments alone but is the process of collective problem solving, the accountability relationships become more complex. Within a broader governance concept the power relationships with actors outside the government are not automatically defined by clear administrative or political rules. It is in this context that enforcement becomes a critical and distinguishing aspect of accountability. This does not necessarily mean that the actor who seeks information and explanation (answerability) is the same as the one that can enforce actions. Frequently those two functions are separated but linked within a governance framework.

1.3 Directions of Accountability

Over time and in different contexts both the questions to which a government is answerable (standards) as well as to whom it might be accountable has changed and different forms and approaches to accountability have evolved. As a consequence different terms have been coined to describe and distinguish this growing accountability agenda.

The agenda has also been expanded to define different directions that accountability relationships may take. The most frequently used terms to describe the directional aspects of accountability are *horizontal* and *vertical*, as well as *downward* and *upward* accountability. Although they have slightly different meanings, these terms are frequently used interchangeably. In this section, we will present the distinguishing aspects as well as interrelated meanings of these terms.

Horizontal accountability describes a relationship between state agencies in the same hierarchical level (e.g., between different line departments), whereas vertical and upward accountability refers to a given hierarchical structure within government. The term downward and vertical accountability is the ability and mechanism of the state to be accountable towards its constituency. On the other hand, upward accountability is usually referred to the accountability of a lower echelon government entity towards its overseeing government agencies. Upward and downward accountability are commonly used in the context of decentralization to characterize the accountability relationships between the decentralized government and the central government (upward accountability) and the between the decentralized government and the constituency (downward accountability).

In the social development literature the term *horizontal and vertical accountability* is often used in a different sense.² Horizontal accountability is referred to as the capacity of state institutions to check on the performance of other public agencies and branches of the government. Horizontal accountability mechanisms are mechanisms inside the state, no matter if they relate to subordinate agencies or decentralized agencies. Vertical accountability, on the other hand, refers to means whereby outside actors seek to enforce standards of good behavior and performance of public officials and service providers. The accountability seekers in vertical accountability arrangements are typically ordinary citizens, mass media, and civil society. Elections are a typical form of vertical accountability.

1.4 What Are the Different Dimensions of Accountability?

Accountability can take many different forms and actors can give an account to various forms in a variety of ways. There are four important questions to be asked to understand various dimensions of an accountability relationship.

A. *To Whom Is Account to Be Rendered?*

As mentioned earlier, accountability is the relationship between the actor and the forum (Boven 2006). According to this definition, the actors render account to at least four types of forums. Each of these forums holds a different kind of power over the actor and demands different kind of information from the actor. They are also therefore likely to apply different set of criteria in judging the actor (Boven 2006).

- *To voters and elected representatives*

This is the most important type of accountability in a democracy. Voters elect their representatives at the local and central level to run their government, both at the central and local levels. Therefore, elected officials render account to the voters during elections.

- *To auditors, inspectors, and controllers*
 Administrative accountability can be both vertical and horizontal (see the previous section on directions of accountability). Vertical administrative accountability relationship is based on hierarchical relationship between local government and higher levels of government, such as laws giving power to a central government ministry (i.e., the Ministry of Local Government or Ministry of Interior) to audit local governments administrative and financial transactions. Horizontal administrative accountability relations happen at the local government level when, for example, their internal control inspectors audit local government units.
- *To the judiciary*
 Legal accountability is an important component of broader accountability framework.³ Especially in the developed world, public sector institutions give account to the judiciary for their conduct. Legal accountability is usually based on specific responsibilities legally conferred upon public sector agencies. In many countries, such as France, there are specialized administrative courts that play an important role as a forum.
- *To the society*
 Efforts to overcome the shortcomings of electoral and administrative accountability systems have produced new forms of societal accountability that enable civil society groups to engage the government more directly. Social accountability is a stronger version of vertical accountability. It refers to the broad range of actions and mechanisms beyond voting that citizens can use to hold the state and providers of public services to account (Ackerman 2003).

B. *Who Should Render Account?*

Public policies go through multiple processes where diverse institutional and individual actors are involved in their formation and implementation. This complexity makes it quite difficult to untangle who contributed in what way. The question in front of the forum is *who should be called to account, interrogation, and judgment?* Typically, two types of actors render the account:

- *Public institutions: corporate accountability*
 All public sector institutions are corporate bodies with a political and administrative leadership. They operate within a certain political, administrative, and legal framework that circumscribes their accountability sphere. Local governments as a whole, as well as individual departments within them can be held accountable to the relevant forum—typically, general citizenry, local councils, judiciary, auditor’s office, and so forth.

- *Public servants: individual accountability*
Individuals in public sector institutions are liable to various forums for their conduct. Individual accountability makes it impossible for public servants to hide behind their organizations. Depending on the conduct, public servants might be called to account by a disciplinary tribunal, external auditor, parliamentary commission, courts, etc.

C. *About What Is Account to Be Rendered?*

Accountability relationships can also be categorized in terms of whether accountability is rendered about the process or outcome. In fact, depending on the focus on process versus outcome, accountability systems could be structured in significantly different ways. Accountability for process refers to “whether or not governments are acting in accord with rules that prescribe how they should or should not behave” (Schroeder 2006: 2). Accountability for outcomes, on the other hand, focuses whether the decisions of governments are in the best interest of their citizens (Schroeder 2006: 2).

The accountability for outcomes emerged as part of the “New Public Management” paradigm in response to the concerns about government performance in terms of providing high-quality services that citizens value. It is an attempt to “shift accountability from complying with rules and regulations to achieving results” (Behn 2001: 27). In this line, public officials are expected to respond to individual citizens through innovative and flexible approaches.

Ideally, accountability is expected to be rendered through both process and performance. Accountability systems focusing too much on the process will more likely be inflexible, so much so that everything would be prescribed as to how things should be done. On the other hand, focusing too much on outcome and results and ignoring how things are done will more likely leave room for corruption or unfairness in the process of getting the results. Behn (2001: 29), in the American context, argues that “in an environment with excessive oversight and regulatory requirements,” most public managers choose to satisfy the test for accountability for finances and fairness. According to him, most public managers make sure that no one can hold them accountable (that is, punish them) for not handling the finances properly; then, if they still have time, resources, organizational capacity, or flexibility left over, they will try to improve performance (Ibid: 30). Other risk-taking and result-seeking executives, on the other hand, may seek “innovative ways to circumvent the formal rules.” The challenge here is whether we can encourage public managers to be “entrepreneurial” while making sure that we can get enough information about their conduct.

The question of “about what the accountability is rendered” could also be answered in terms of the political, administrative, and fiscal dimensions of government decision-making. *Political accountability* refers to the account giving to the electorate about the way government business is conducted (this form of accountability usually refers to

political leaders being held accountable through local elections but it also refers to other political aspects such as campaign finances, legislative performance, etc.). *Administrative accountability* covers administrative decisions (i.e., decisions about recruitment, procurement, land use, planning, etc.) of local officials. *Fiscal accountability* refers to the financial planning and decision-making process and its outcomes. This includes accountability for sound and transparent public expenditure and financial management systems, overall fiscal discipline, allocation of resources to priority needs, and the efficient and effective allocation of public services in an effective, efficient, transparent, and rules-based public financial management (PFM) system.

The discussion about process versus outcomes is still relevant in each dimension. For example, in the context of administrative accountability, citizens may be highly satisfied about the quality of a particular service they receive (outcome) but whether or not the contract to the service provider was awarded in a fair and competitive process is still an important process question that needs to be addressed through accountability mechanisms.

D. Why Render Account?

- *Involuntary: the actor is forced*

Involuntary account giving occurs in situations where the forum formally wields powers over the actor. The forum has the formal and legal power to compel the actor to give account and be judged. Invariably, these are supported by formal sanction mechanisms if the account holder is found delinquent or deficient.

- *Voluntary: the actor voluntarily gives an account*

In voluntary forms of account giving, the actor voluntarily renders account with no legal obligation. Social norms and behaviors can dictate the actor to provide account to the forum. Despite the non-formal nature of the account there can be sanctions.

2. Supply- and Demand-Side: Public and Social Accountability

Skeptics of public sector reforms that promote the idea of extending the discretionary powers of lower levels bureaucrats or elected officials often point out the risk that discretionary powers as such are prone to abuse. They therefore argue that discretion should be limited so that public officials could be kept under check. Yet, the real question is not about whether to give more or less discretion, but how to control it. The major objective of this section is to explore and analyze the linkages between building state capacity and increasing social accountability and assess how the level of discretion relates to building effective and democratic state and society relations. The effort is to bridge

approaches that have traditionally ignored each other—supply and demand-side. Public sector specialists advocate for strengthening supply-side institutions of control. On the other hand, social development approaches directly stress the importance of demand-side initiatives that focus on citizen involvement and participation/civic engagement, while putting less emphasis on state capacity building and the need to work with the state sector. Many advocates of these approaches tend to discount any role for the state in terms of building capacity and increasing accountability and transparency.

2.1 Public Sector Accountability

Public accountability refers to institutionalized practice of account giving by civil servants and public sector institutions. Although the literature on public accountability is devoted to the accountability of central governments, the issue is equally important for local governments, especially in the era of decentralization. Public accountability as a supply-side approach is critical in establishing aggregate controls, prioritization, and efficiency in local government operations.

Public accountability is the hallmark of and a *sine qua non* for good governance (Bovens 2005). It is the obligation of public authorities (governments, elected representatives, corporate, and other governing bodies) to explain publicly, fully, and fairly how they are carrying out responsibilities that affect the public in important ways. Public accountability focuses on public sector managers who spend public money, exercise public authority, and manage a corporate body under public law. Public account giving provides political representatives⁴ and voters with the necessary inputs for judging the fairness, effectiveness, and efficiency of their governance system (Manin, Przeworski, and Stokes 1999).

Historically, the concept of public accountability is derived from accounting and bookkeeping (Bovens 2005). Today, it has moved far beyond bookkeeping and is at the center of good governance. Public sector governance encompasses the policies and processes to provide reasonable level of assurances to the public that objectives are met and that operations are carried out in an ethical and accountable manner. Public sector governance includes the means by which goals are established and accomplished, as well as activities that ensure appropriate behavior of civil servants—thereby reducing the risk of corruption (Institute of Auditors 2006).

The recent developments on public sector reforms—what has been called New Public Management—are actually about the evolution of public accountability. In the traditional Weberian model of government, accountability involves the adherence to a set of process requirements and rules for conducting people's business. According to this model, governments are accountable if they adhere to established processes when governing. This model is more process oriented and promotes following the rules and

regulations in handling people's money (public financial management) rather than the identification of people's needs and preferences and providing services efficiently and effectively.

In the last two decades, the Weberian "monolithic systems of hierarchical political and organizational accountability relations has been under serious pressure and is slowly giving way to a more diversified and pluralistic set of accountability relationships" (Bovens 2005: 196). In the new public management model, accountability has a different meaning, focused more directly on how government interacts with citizens. In this model, governments are accountable if they engage with citizens in a transparent way and are responsible to citizens' needs. The promotion of the establishment of ombudsmen, auditors, and independent inspectors in the New Public Management model puts the emphasis on administrative accountability, which forces us to rethink the classical top-down, principal agent model. These new accountability institutions influence the accountability relationship in the principal agent framework.⁵ Even though most of these accountability institutions report either to the elected leaders—Parliament—or the executive branch, "they are not part of the direct chain of principal-agent relations (Bovens 2005: 196). They establish diagonal accountability relationship to mediate the accountability between an agent and a principal.

In the public sector application of the principal agent framework, public accountability is important in providing a democratic means to monitor and control government conduct, in helping to prevent public servants' abuses of their power, and in enhancing the learning capacity and effectiveness of the public servants (Aucoin and Heintzman 2000). The citizens, who are the ultimate principals, have empowered their popular representatives to draft and enforce laws and policies. These representatives in turn have transferred the power to run the public sector machine to the executive branch of the government. Ministers subsequently entrust the daily running of the public sector to their staff. In this chain relationship, accountability actors frequently change their roles as principals and agents. Therefore, public sector accountability is an essential precondition for the democratic process to work as it provides citizens with the information needed for judging the propriety and effectiveness of public sector (Manin, Przeworski, and Stokes 1999).

In this framework, public sector accountability institutions and tools are designed to further the objectives of the citizens in ensuring efficient and effective use of their tax money. They do so by constraining discretion of public sector actors in use of public resources. These supply-side tools are meant to address information asymmetry issues present in the principal agent framework. Bureaucrats, as agents, have considerably more information than that available to the citizen, the principals. This information asymmetry allows agents to indulge in opportunistic behavior. Public sector accountability institutions and tools, such as ombudsmen, auditors, and independent inspectors, are intended to be countervailing institutions to enforce accountable governance. However,

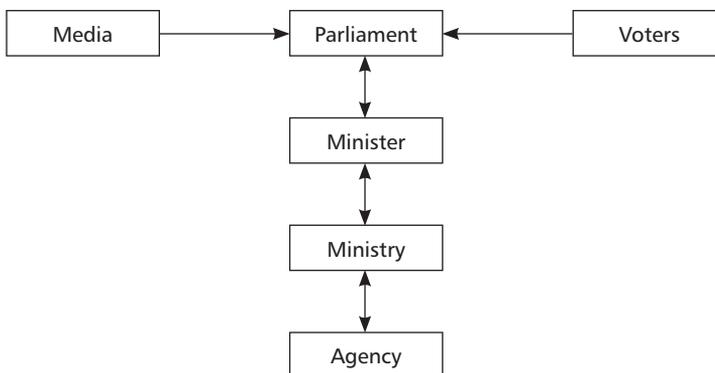
in many countries, weak judicial systems and an inadequate provision of information make it difficult to promote public accountability.

Public sector accountability is comprised of three main dimensions: political, administrative, and financial.⁶ The political dimension is about setting the rules for citizens to elect and interact with their elected leaders and they define degree of oversight that those elected leaders have over the executive arm of government and bureaucracy. Administrative arrangements establish the civil service rules that determine the autonomy and incentive structure for enabling accountable and well-functioning central and local bureaucracies. Fiscal arrangements determine the role of central and local governments in service delivery by assigning service delivery responsibilities. Furthermore, they define the funding level for governments to deliver these services.

Political accountability is a process “whereby citizens hold their governors to account for their behavior and performance directly through elections” (Aucoin and Heintzman 2000). However, in modern democracies it is exercised indirectly, i.e., it is the elected leaders, not citizens, who hold service civil servants accountable through hierarchical structures (see Figure 1). For example, in parliamentary systems, political accountability is with the cabinet ministers who are responsible for the functioning of their ministries and civil servants.⁷ In presidential systems senior level public sector managers are directly accountable to the legislatures.

Delegation of public authority from elected officials to unelected bureaucrats is a fact of contemporary democracies. Discretion is given to public sector officials so that they are able to use their best judgment to meet the public interest.⁸

Figure 1.
Vertical Accountability



Source: Bovens 2005: 199.

Administrative accountability refers to local civil servants being accountable to their top administrative officers and to outside bodies such as public audit officers, ombudsmen, and regulators, or a particular administrative agency, or a board/committee about the use of their administrative discretion. Administrative accountability mechanisms include offices within agencies or ministries and practices within administrative processes designed to ensure that the decisions and actions of public officials account for the interest of citizens (see Table 1). Other mechanisms for administrative accountability include *independent auditors* who scrutinize the use of public funds for signs of misuse, *administrative courts* that hear citizens' complaints about agency decisions, and *ethics rules* protecting so-called whistleblowers—those within government who speak out about corruption or abuse of official authority—from reprisals.

Administrative accountability aims at monitoring and regulating processes of public administration to ensure the quality, transparency, and efficiency and implementation of administrative processes in line with administrative decision-making. This involves collecting information, evaluating the possible alternative solutions, determining the best options available, assessing different ways of implementation of decisions, and appraising of the possible effects on public interests or relevant parties and individuals.

On the supply-side, measures to improve downward administrative accountability include independent judicial/quasi-judicial agencies that investigate cases of government corruption and misconduct; regular administrative audits (external audits) of government transactions through permanent or *ad hoc* independent entities; administrative courts that deal with compliance on regulatory decision-making and actions; a national procurement strategy for local governments; well-defined procurement rules and processes; independent procurement audits; standards for service delivery and reward performance; strong information systems to monitor service quality; clear rules regarding civil service practices (payrolls, staff levels, recruitment practices, staff performance); systems for periodic monitoring and timely revisions (often through local government commissions) of civil service rules; and a flexible career and performance management supported by a civil service system with merit-based recruitment.

Administrative decision-making is a complex procedure that takes into account the objectives set by political leadership, statutory provisions, and other governmental regulations. Consequently, administrative accountability is achieved through the use of a variety of mechanisms—information provision, consultation/oversight, active participation (see Table 1)—designed to prevent corruption and ensure that public officials are answerable and accessible to the people they serve. There is a hierarchical accountability relationship within the public sector. Civil servants are responsible to the top administrative officers and ministers. They are also responsible to parliamentary commissioners, public audit officers, ombudsmen, and regulators as well as a particular administrative agency or board.⁹

Table 1.
Administrative Mechanisms for Advancing Public Sector Accountability

Accountability Mechanism	Task	Method
Information Provision	Provision of information	Mandatory provision of information by the government through annual reports, brochures, newsletters, and the publication of normative acts in newspapers.
Consultation/Oversight	Notice and comment on rule making	Requirement that draft normative laws be published prior to their enactment.
	Public hearing	Public hearings to be held prior to rule making and the enactment of a law.
	Administrative procedures	Administrative actions requiring informing citizen prior to any legislation or other action.
	Advisory committee	Permanent or <i>ad hoc</i> bodies that provide input to government in various policy areas.
Active Participation	Right to petition	The public has the right to propose the adoption, amendment, or repeal of a normative act.
	Consensus/negotiated rule making	Councils that engage groups to reach consensus with respect to policy initiatives.

Financial accountability is about promoting and reporting publicly on performance. Public financial accountability requires that governments manage finances prudently; “that they integrate their financial and non-financial reporting, control, budgeting, and performance; that they report comprehensively on what they have achieved with their expenditure of funds...” (Sahgal and Chakrapani 2000).

Public expenditure management (PEM) and public financial management (PFM) systems are essential components of public financial accountability.¹⁰ Sound, transparent, and rules-based public expenditure and financial management systems are fundamental building blocks for good public sector governance. Public expenditure and financial management arrangements should promote transparency and accountability in the use of public resources, ensuring allocation of public resources in accordance with citizens’ priorities and supporting aggregate fiscal discipline, in line with core dimensions defined by the Public Expenditure and Financial Accountability (PEFA) initiative (see Box 1).

Box 1.

Public Expenditure and Financial Accountability (PEFA)

The Public Expenditure and Financial Accountability (PEFA) initiative defines these core dimensions of effective PEM and PFM systems:

1. *Credibility of the budget*: The budget is realistic and is implemented as intended.
2. *Comprehensiveness and transparency*: The budget and the fiscal risk oversight are comprehensive and fiscal and budget information is accessible to public.
3. *Policy-based budgeting*: The budget is prepared with due regard to government policy.
4. *Predictability and control in budget execution*: The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds.
5. *Accounting, recording and reporting*: Adequate records and information are produced, maintained, and disseminated to meet decision-making control, management, and reporting purposes.
6. *External scrutiny and audit*: Arrangements for scrutiny of public finances and follow up by executive are operating.

Source: PEFA 2005.

2.2 Social Accountability

—The Emergence of a New Accountability Agenda

In a democracy, citizens delegate power to elected representatives and bureaucrats on one condition: that they will be able to hold them accountable for their performance—either directly, by voting them out of office, or indirectly, through the government system of checks and balances. Both accountability mechanisms, however, have been plagued by structural and contextual problems that limit their effectiveness. In response, citizens and civil society organizations have unleashed a broad range of experiments and innovations aimed at enhancing government accountability. The global trends towards democratization and decentralization have opened up the potential that the local space offers for social accountability initiatives.¹¹

Elections have proven to be a very weak and blunt instrument for citizens to hold the state to account, for several reasons: (a) elections only hold elected officials accountable, and not appointed bureaucrats, (b) elections cannot give clear accountability signals to individual office holders because voters have only one shot at punishing or rewarding numerous governmental decisions and because we can never know whether they are enforcing prospective or retrospective controls; (c) voting is a decentralized strategic action—since it is hard for citizens to coordinate the orientation of their votes, the

power of voting as a control mechanism is weakened; and (d) shortages of information prevent voters from having an adequate standard for evaluating government performance and decisions.¹²

Public accountability mechanisms, such as the ombudsmen, anti-corruption agencies, audit offices, or legislative investigative commissions, have to face the structural impossibility of monitoring the almost infinite number of government actions (and inactions) as well as the contextual difficulty of the lack of adequate funding, limited enforcement capacity, or the absence of second order accountability (i.e., holding accounting agencies accountable).¹³

The limitations of both electoral and public accountability mechanisms have encouraged an expansion in the repertoire of instruments through which citizens can hold the state to account. These instruments include traditional practices such as public demonstrations, protests, and investigative journalism, as well as more innovative ones such as participatory budgeting, social audits, or citizen report cards. What they have in common is to try to build accountability through civic engagement—social accountability.

Social accountability refers to an approach toward building accountability that relies on civic engagement—in which ordinary citizens and/or civil society organization demand accountability.¹⁴ Other terms used to refer to the same phenomenon include “citizen or civic oversight/monitoring,” “citizen demands for accountability,” or “accountability demands.” Strictly speaking, social accountability is not a new type of accountability but it denotes an expansion in the mechanisms and methods for downward accountability (from elected representatives to citizens).

The diffusion of social accountability initiatives can be seen as part of the emergence of a broader “new accountability agenda.”¹⁵ This new agenda responds to the systemic failures of conventional institutions of democratic accountability to overcome the entrenched processes of elite capture and elite bias, and deliver accountable governance to poor and marginalized groups in society. The new agenda also challenges the conventional perspective on the role of civil society in accountability. Traditionally, the emphasis has been on a clear separation, an arms-length relation, between state and society.¹⁶ In contrast, the new agenda shows how citizen oversight can flourish precisely in institutional forms where the boundaries between state and society are blurred or confused. These institutional forms, which have been termed “co-governance for accountability,” violate explicitly the separation between state and society, inviting civil society to the inner chambers of the state to “participate directly in the core functions of government itself.”¹⁷ Those functions could be the elaboration and control of local budgets through participatory budgeting, or the hiring and firing of principals through local school councils, or the auditing of local government managed public works programs through social audits and freedom of access to information laws.¹⁸

The role of citizen oversight is not to replace but to complement and enhance public accountability mechanisms. The concepts of “police patrol” and “fire alarm”

oversight mechanisms illustrate well this complementary role. “Police patrol” oversight is the traditional modality in which supervisory agencies operate, trying to keep a constant eye on those they are supposed to monitor. In contrast, “fire alarm” oversight happens when an agency relies on external actors to detect when there are problems (to “sound the alarm”) and then focuses its attention particularly carefully on those areas.¹⁹

Citizens demands for accountability can contribute to (i) *improved governance* by monitoring that authority is exercised in a transparent, responsive, and fair way; (ii) *improved service delivery* by providing feedback to service providers on areas that need improvement and helping to discipline them; and (iii) *deepening democracy* by allowing citizens to exercise their right to expect and ensure that government acts in the best interests of people.

Responsiveness and (social) accountability are related but distinct concepts that often get conflated when discussing social accountability. Efforts to build government responsiveness by increasing citizen voice in decisions can create the enabling conditions for citizen oversight. However, *voice efforts alone do not constitute instances of social accountability*. For social accountability to happen, citizens and/or civil society organizations need to play an active role in demanding explanations (answerability) and/or in imposing sanctions/rewards (enforcement) about government performance. For instance, a participatory municipal plan that actively involves citizens in defining local investment priorities can increase government responsiveness. It becomes a social accountability initiative *only* if it facilitates a dialogue/debate between citizens and local governments about the previous year/s plan and budget execution.²⁰

3. Accountability as a Function of Discretion

The basic assumption of this chapter is that accountability is a function of discretion. Without discretion, there is no accountability. This means that public sector officials should first be provided with a meaningful level of discretion and then they should be held accountable about how they use this discretion. In making governments accountable, upward and downward accountability structures should reinforce one another and downward accountability should be strengthened through both public and social accountability approaches.²¹

Discretion is given to public sector officials so that they are able to use their best judgment to meet the public interest. The broad definition of discretion focuses on the public sector in application of rules and policies on a day-to-day basis.²² It is defined as an exercise of judgment and choice by public officials to apply rules and implement policies at the field level. The basic premise is that public sector officials are knowledgeable and experienced to apply rules to particular situations and contexts, which increases

the effectiveness of rules and policies, improves performance, and is inherently flexible and responsive to public needs and demands.

The establishment of discretionary space calls for the establishment of safeguards against its abuse as well. Despite the benefits and practicality of discretion, there are tendencies for misuse and abuse of discretionary power, to use discretion for private gain, and public officials being unduly influenced and captured by elite groups due to lack of checks and balances to discretionary power. Although discretion follows from formal rules and norms, law and rules are generally vague and often incomplete to deal with every situation and circumstance. Legal and judicial reforms do not address implementation and enforcement of policies and rules. Additionally, there are numerous informal rules and norms that are required for the effective operation of public sector mechanisms. Implementation and enforcement of laws relies heavily on informal norms of all types, including professional, legal, community, and moral. However, there is insufficient attention given to strengthening accountability and providing checks and balances to discretion, especially informal mechanisms.

The issue of discretion and the potential for abuse of power is critical to strong state-society relations. In many developing countries, the capacity of enforcement institutions for rules and laws is weak. Therefore, there is a potential for the abuse of power. In these countries, monitoring and controlling discretion constitutes a major challenge to their public sector reform efforts.

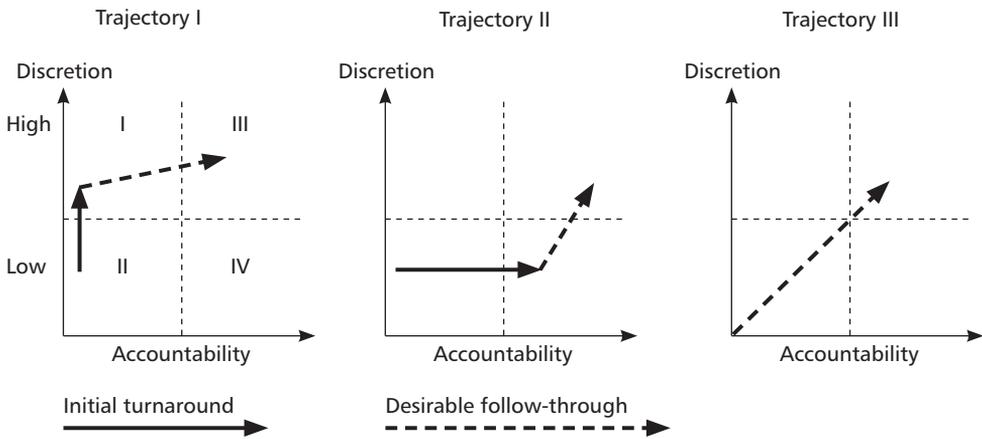
4. Linking Discretion and Accountability: Establishing Trajectories of Reform

Based on the theoretical elements presented in the earlier sections, good governance presumes an integrated accountability framework that balances a high degree of local discretion with a high degree of accountability.

Yet, this is the ideal scenario, assuming that public sector reforms at all dimensions (political, administrative, and fiscal) are fully implemented and they successfully integrate both public and social accountability approaches. In reality, countries are at different stages of public sector reforms, with varying degrees of focus on the linkages between discretion and accountability. Figure 2 shows three possible trajectories for good governance turnarounds and the related scenarios for the sequencing of governance reforms.²³ The starting point for all trajectories is quadrant II where both discretion and accountability are very low—highly centralized countries with no government accountability. The end point is quadrant III where public officials have a high degree of discretionary power accompanied with a high degree of accountability towards citizens. Countries that are at the high end of discretion but lacking focus on accountability fall under quadrant I in Figure 2. This kind of “high discretion-low accountability” combination may actually

create perverse incentives for governments, making them vulnerable to elite capture or prone to reckless decision-making. Quadrant IV, on the other hand, signifies countries that are more focused on accountability structures governing governance systems. Yet, in the absence of high discretion for decision-making, governments in these countries are more likely to be overloaded by accountability requirements. Absence of discretion also implies that governments have skewed incentives to be heavily process oriented.

Figure 2.
Governance Turnarounds: Trajectories



Source: Adopted from Levy 2006.

The first trajectory in Figure 2 signifies a country context where the focus is on discretion in the short-run. Decentralization reforms are good examples of such a strategy (e.g., big-bang decentralization in Indonesia). In this group of countries, decentralization reforms placed an emphasis on increasing political, administrative, and fiscal discretionary power of local governments initially. Several well-known examples of decentralization reforms—most notably, in recent times, Indonesia—exemplify this trajectory. In Indonesia, for example, the “big bang” decentralization devolved functions and resources through two national laws (Law 22/1999 and Law 25/1999, respectively). Supporting laws and regulations, as well as other institutional measures, to strengthen control and improve accountability of local governments were introduced much later. In fact, the process of bringing greater accountability in local governance has been an ongoing process in Indonesia’s decentralization.

The next step in their reform efforts is to strengthen accountability of local governments towards citizens. The second trajectory denotes a scenario where the national

decision-makers put a higher priority on promoting political pluralism, administrative accountability, and financial safeguards in the short-run, as was the case with ex-Communist transition countries in Eastern Europe.

The third trajectory represents a balanced situation where both discretion and accountability are strengthened simultaneously. Arguably, in the real world, there are few instances of a perfect diagonal trajectory.

5. The Way Forward: Towards a Comprehensive Accountability Framework

Until recently, efforts to foster good governance focused on strengthening the supply-side of accountability in state institutions. Accordingly, donor initiatives supported institution building in developing countries to increase the *supply* of governance processes through reforming public institutions. More recently, the development community has come to realize that domestic *demand* for accountability, originating in civil society entities and the public at large, is at least as important for development as supply-side mechanisms. Also referred to as *social accountability*, demand-side refers to an approach toward building accountability that relies on civic engagement—in which ordinary citizens and/or civil society organizations demand accountability. Accordingly, this chapter argues that downward accountability of governments follows the discretions provided to governments and it should be strengthened by integrated approaches marrying supply-side public sector accountability with demand-side social accountability instruments.

We have described in the previous sections how public and social accountability approaches could help reinforce downward accountability and discussed the possible trajectories to reach a state of high discretion with strong accountability (quadrant III) supported by these approaches.

Whatever the eventual trajectory may be, reaching quadrant III requires taking certain actions on the part of policymakers. In order to guide this process, Table 2 provides a set of recommendations. These recommendations are divided into two groups of action—supply- and demand-sides—denoting the twin focus we have been emphasizing throughout this chapter: improving public sector capacity while concurrently developing institutions of demand-side of good governance. They aim to inform various parties involved about the issues in designing a public sector reform strategy.

It should be stressed that Table 2 does not pretend to be a prescriptive “cookbook” that is a recipe for all countries and contexts—rather, it aims to provide a concise list of issues that may be relevant to a larger set of countries and needs to be prioritized and sequenced.

Table 2.
Policy Recommendations to Strengthen Accountability

POLITICAL SETTING AND ACCOUNTABILITY

Supply-side	Demand-side
<ul style="list-style-type: none"> ▪ Review and revise, as needed, the role of campaign financing rules that may favor large, centralized parties and make it more difficult for local candidates or new parties to compete ▪ Establish transparent rules for financing of elections, and monitor and enforce these ▪ Improve the quality of the electoral system's recall, write-in, and independent candidate options ▪ Ensure representation of marginalized/ vulnerable groups (reserved seats, quota systems) ▪ Institute consultation mechanisms such as public hearings and integrate these into formal decision-making processes ▪ Secure and strengthen the role of elected body/ies in overseeing government operations ▪ Strengthen electoral system <ul style="list-style-type: none"> – Ensure free and fair elections – Clearly define rules regarding electoral system and broader guidelines for political competition ▪ Allow for competitive multi-party systems; remove restrictions before party competition ▪ Provide legal safeguards against dismissal of elected officials on frivolous grounds ▪ Ensure a legally mandated length of term for elected public officials (which is not too short or too long to serve citizens) ▪ Establish clear separation of power between the executive and legislative bodies ▪ Assign necessary functions and mechanisms, and strengthen resources to elected representatives for exercising their oversight functions ▪ Allow, within prescribed rules, for voting measures beyond elections, i.e., authority for governments to initiate referendum 	<ul style="list-style-type: none"> ▪ Allow for citizen initiated legislation (i.e., petition) and referendum ▪ Establish procedures for public petitions to adopt, amend, or repeal an act, legislation, or executive order ▪ Allow for citizens to initiate recall of elected public officials ▪ Allow for citizens to demand public hearings on policy decisions and actions ▪ Establish citizen ombudsman offices

Table 2. (continued)
Policy Recommendations to Strengthen Accountability

ADMINISTRATIVE DISCRETION AND ACCOUNTABILITY

Supply-side	Demand-side
<ul style="list-style-type: none"> ▪ Regularly conduct administrative audits (external audit) on government transactions through permanent or <i>ad hoc</i> independent entities ▪ Establish independent judicial/quasi-judicial agencies to investigate cases of government corruption and misconduct ▪ Establish specialized administrative courts to deal with compliance on regulatory decision-making and actions ▪ Develop national procurement strategy to strengthen procurement rules and processes; institutionalize independent procurement audits ▪ Develop ethics rules, codes of conduct, and professional practice guidelines for government employees ▪ Introduce a flexible career and performance management supported by a civil service system with merit-based recruitment ▪ Establish clear rules regarding civil service practices (payrolls, staff levels, recruitment practices, staff performance) and develop systems for periodic monitoring and timely revisions ▪ Institute a grievance/complaint system as well as a whistleblower protection system ▪ Set standards for service delivery and reward performance. Strengthen information systems to monitor service quality 	<ul style="list-style-type: none"> ▪ Secure citizen participation in decision-making processes regarding administrative affairs through neighborhood councils, community councils ▪ Allow citizens to challenge administrative decisions made by government departments ▪ Support public involvement in contracting and implementation of public works projects through social audit committees ▪ Develop citizens charters for empowering them in their interactions with local service providers ▪ Support public oversight mechanisms to provide citizens a channel to oversee local service delivery and introduce measures for assessing citizen satisfaction with service delivery (scorecards, service delivery surveys) ▪ Integrate service delivery performance into formal intergovernmental processes and provide incentives for good performance

Table 2. (continued)
Policy Recommendations to Strengthen Accountability

FINANCIAL/FISCAL DISCRETION AND ACCOUNTABILITY	
Supply-side	Demand-side
<ul style="list-style-type: none"> ▪ Strengthen local capacity for budgeting and public financial management ▪ Create a modern chart of accounts system for reporting revenues and expenses ▪ Establish criteria for revenue mobilization, expenditure efficiency, and financial management discipline and link performance to rewards ▪ Publicize approved budgets; provide open and timely access to budget execution information; publicize end of fiscal year budget ▪ Develop a system of performance monitoring and evaluation for tracking budget and public expenditure outcomes, and make info publicly available ▪ Strengthen public audit systems and make audit findings publicly available 	<ul style="list-style-type: none"> ▪ Make government financial information (including budgets and end-of-year financial statements) easily accessible to public ▪ Strengthen public involvement in budgetary process through participatory budgeting practices ▪ Introduce gender-sensitive planning, budgeting, and resource allocation —reinforced by gender audits ▪ Make budget information available to the public and influence budget allocation through independent budget analysis ▪ Monitor budget execution and leakage of funds through participatory public expenditure tracking

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Notes

- ¹ The note explains the CAR (Capability, Accountability, and Responsiveness Framework) used by the U.K. government's governance and conflict advisers.
- ² Malena, Carmen, Forster Reiner, and Janmejy Singh. 2004. "Social Accountability, An Introduction to the Concept and Emerging Practice." Social Development Paper No. 76. Washington, D.C.: World Bank.
- ³ Although legal accountability via judicial systems is an important component of accountability framework, it does not come under the purview of this chapter.
- ⁴ The formal doctrine of elected representatives' responsibility rests upon the notion of representative democracy and parliamentary sovereignty. The elected representatives of people—parliament—bring the government—the executive—to account. Parliament enacts administrative laws to enforce accountability. On the other hand, poor governance and a lack of public sector accountability may result from a number of factors including civil service incompetence, lack of efficient institutions, and pervasive corruption (Schaeffer 2005).
- ⁵ The Principal-Agent (PA) theory provides for a conceptual framework for the understanding of public accountability processes. Its basic insight is that the principal, P, hires the agent, A, to undertake a particular task, but P suffers from an information asymmetry problem in motivating and controlling A. In both economics literature (e.g., Arrow 1985; Rees 1985; Laffont 1989) and its public management extensions (e.g., Jensen and Meckling 1976;

Andrews and Shah 2005) the solution to a PA problem involves the development of an optimal incentive package that furthers the objectives of the principal and constrains the actions of the agent.

- ⁶ Legal accountability is an important component of public sector accountability; however, legal issues are beyond the scope of this paper.
- ⁷ In many parliamentary systems, civil servants also appear in front of political forums, such as parliamentary committees and give account to parliamentary inquiries.
- ⁸ The broad definition of discretion focuses on the public sector in application of rules and policies on a day-to-day basis. See Handler (1986) for a general discussion on discretion.
- ⁹ These agencies have been set up by the legislature to make inquiries and obtain information and finally to make regulations or judgments. Although their judgments may lack sufficient legal sanctions, they cause departmental embarrassment and, to a limited extent, governmental changes in policy and decisions (Zarei 2000).
- ¹⁰ The terms public expenditure and public financial management are often used interchangeably to refer to all components of budgeting process. Public expenditure management is a broad term referring to both “upstream” and “downstream” phases of budgeting and budget execution processes. Public expenditure management includes all phases of the budget cycle, including the preparation of the budget, internal control and audit, procurement, monitoring and reporting arrangements, and external audit. On the other hand, public financial management has a narrower definition; it entails to downstream phase of budgeting—namely budget execution, accounting, control, reporting, monitoring, and evaluation (Allen, Schiavo-Campo, and Garrity 2004).
- ¹¹ Initially, the agenda for social accountability was mostly driven by social movements. Increasingly, however, reformist politicians and government officials are actively supporting these initiatives. These politicians understand that sharing their power increases their legitimacy, which in turn is translated into political gains and less transactional cost in enforcing decisions. Greater trust and legitimacy is particularly effective when reformist politicians and technocrats face entrenched resistance from within the bureaucracy and political system. The donor community has also given greater attention to social accountability instruments, acknowledging that traditional public reforms are necessary but not sufficient for good governance.
- ¹² Manin, Przeworski, and Stokes (1999); Ackerman (2003).
- ¹³ Ackerman (2003).
- ¹⁴ The concept of social accountability underlines both the right and the correspondent responsibility of citizens to expect and ensure that government acts in the best interests of the people. Consequently, social accountability initiatives help citizens to understand their civic rights and play a proactive and responsive role in exercising those rights.
- ¹⁵ Goetz and Jenkins (2005).
- ¹⁶ The position that state-society collaboration hinders society’s capacity to control the state has been entrenched in the literature, particularly in the social movement literature. It can be traced to the classic text by Piven and Cloward (1979) for whom “poor people’s movements”

could be effective only if they totally rejected cooperation of any kind with state agencies, and pursued the strategy of making a nuisance of themselves to the state apparatus. Much of the social movement literature has focused on the need to avoid co-optation and losing autonomy.

- ¹⁷ Ackerman (2005) has summarized this literature (see citations). While there is a previous literature that showed how mixing state and society could lead to positive, synergistic, development outcomes (see articles by Evans, Ostrom, Lam, and Tendler in the 1996 issue of *World Development* 24 [6]), it is more recently that this argument has been articulated for social accountability.
- ¹⁸ See Baiocchi (2001) and Abers (2000) for participatory budgeting, Fung (2003) for the case of Chicago schools, and Jenkins and Goetz (1999a) for social audits.
- ¹⁹ McCubbins and Schwartz (1984). A similar emphasis on the complementary role of citizen oversight appears throughout the literature. See Paul (1992) on the relationship between “exit”/“voice” and control.
- ²⁰ Citizens can only demand explanations or impose sanctions/rewards with respect to actions or decisions that government has taken in the past (i.e., the budget execution of the previous year). In that sense, (social) accountability is always an *ex-post* relationship. However, in some cases the demand for explanations can refer to formal government proposals for future action (i.e., a draft budget that local executive sends to the legislative), in which cases it is possible to talk of *ex-ante* accountability.
- ²¹ We use the term *downward* accountability to describe the ability of the government to be accountable towards its constituency (*supply-side of governance*). On the other hand, social accountability is about affirming and operationalizing voice in accountability relationship between citizens, power holders, and service providers. It relies on civic engagement—civil society led accountability activities (*demand-side of governance*).
- ²² See Handler (1986) for a general discussion on discretion.
- ²³ Admittedly, neither one of these trajectories is superior to others.

Public Sector Integrity

János Bertók

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Abstract

Integrity in public decision-making is vital for maintaining trust in government and the public service. Experience shows that building a culture of integrity requires the development and upgrade of mechanisms for ensuring that public office is used for the public interest.

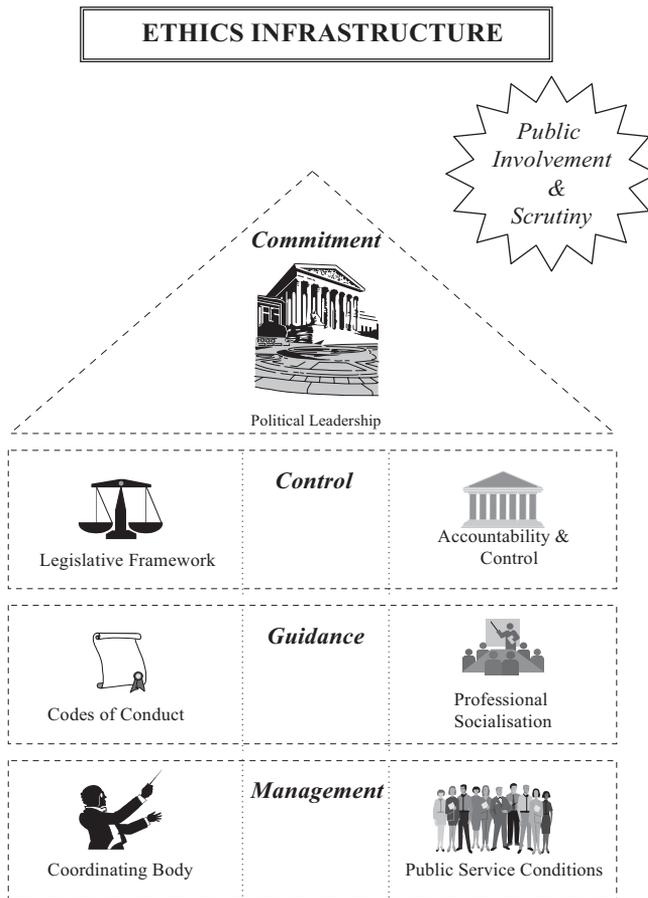
This chapter focuses on the following key aspects of enhancing integrity and resistance to corruption in public organizations, namely:

1. What are the key components of building a sound integrity framework?
2. How to address emerging risks to integrity and resistance to corruption?
3. How to measure corruption and integrity?
4. What role international organizations play in the anti-corruption movement?

1. Elements of Ethics Infrastructure

Today it is widely recognized that the corruption of public officials is more than a question of individual criminal behavior; it is also the result of systemic failure of governance and public management mechanisms. This first section highlights the lessons learned in building a strong framework for integrity and corruption resistance in developed democracies (OECD 2000 and OECD 1996).

Figure 1.
Elements and Functions of Ethics Infrastructure



Source: OECD. 1996. *Ethics in the Public Service: Current Issues and Practices*. Public Management Occasional Papers No. 14, p. 26. Available online: <http://www.oecd.org/dataoecd/59/24/1898992.pdf>.

Control, guidance, and management have been identified over a decade ago as critical functions for a sound “Ethics Infrastructure.” They support in a mutually reinforcing way the combination of relevant laws, institutions, and mechanisms in place to prevent corruption and promote integrity in the public service.

1.1 Political Commitment and Ethical Leadership

In the absence of sustained political commitment to ethical behavior in public organizations, efforts to encourage such behavior will be in vain. Attempts to improve public sector ethics in OECD countries have been sponsored at the highest political levels, such as the approval of comprehensive anti-corruption strategies and programs requested by the President of Mexico and the Republic of Korea, or anti-corruption programs adopted by the government in Hungary in 2003 or Poland in 2006. Other actions, such as the integrity measures sponsored by the Minister of the Interior in the Netherlands in 1995 or the eleven inquiries of the Committee on Standards in Public Life, set up in 1994 by the Prime Minister in the United Kingdom, have demonstrated strong political support. Furthermore, political leaders and senior public servants also serve as important role models by setting example for public servants.

1.2 Workable Codes of Conduct

Codes of conduct play a vital role in stating the expected standards of behavior, particularly in OECD countries that have reduced the rules applying to public servants and have adopted more “managerial” styles of public management. New Zealand, in June 2007, and the United Kingdom, in 2006, issued codes of conduct for the whole public service from which individual agencies may design tailored institutional codes to reflect their particular objectives and mission. In other countries (e.g., Netherlands), these codes are all agency-based. The ethical issues confronting an employee of a defense ministry might vary significantly from those facing social security officials. Codes may be criticized for being too specific or too general, unworkable, unused, unknown, or merely that simplistic statements of rules are not the ideal medium for answering complicated ethical dilemmas faced by public servants.

1.3 Professional Socialization Mechanisms

However, the content of the codes of conduct or even legal provisions remains simply words on paper, if it is not adequately communicated and inculcated. Socialization

mechanisms are the processes by which public servants learn and adopt ethical norms, standards of conduct, and public service values. Training—both induction and ongoing—is an essential element to raise ethics awareness and develop skills capable of solving ethical dilemmas. Ethics, for example, now constitutes an integral part of the initial training of future managers in Belgium, whereas all senior private sector entrants to the civil service in the United Kingdom focus on ethics issues in their mandatory induction training. In the same way, training on vulnerable areas can help public servants solve ethical dilemmas by defining practices for managing organizational and strategic risks proactively.

1.4 Supportive Public Service Conditions

The high standards of ethical conduct expected of public officials are one side of the coin. The other side is a “package” which provides decent working and living conditions for the “servants of the public.” This “package” consists of such basic elements as sufficient job security, the prospect of possible promotion and a career, fair remuneration, and/or social appreciation. Fair and impartial human resources management policies could ensure that the selection and promotion processes in the public sector would be based on general professional requirements, and other factors such as direct political intervention would be minimized. If public servants are feeling underpaid, overworked, and insecure, then they are less likely to embrace initiatives to improve their performance, including the ethical domain.

1.5 Coordinating Body

These take various forms—parliamentary committees, central government agencies, or specially created bodies—and assume various functions:

- “Watchdog” including investigation, such as France’s permanent anti-corruption investigation commission, Korea’s Independent Commission against Corruption, or the New South Wales Independent Commission against Corruption in Australia;
 - “General promoter” of public sector ethics, a role performed by the Department of Employers Affairs in Norway and the New Zealand State Services Commission;
 - “Counselor and adviser,” such as the United States Office of Government Ethics and the Canadian Ethics Commissioner that also plays the role of “watchdog”;
- or

- “Permanent ethics workshop” as the Committee on Standards in Public Life in the United Kingdom.

The existence of a coordinating body should not, however, be construed as absolving departments and managers of the responsibility for ensuring ethical conduct within their jurisdictions.

1.6 Effective Legal Framework

The legal framework is the “teeth” of the overall ethics infrastructure. Laws and regulations define the basic standards of behavior for public servants and enforce them through systems of investigation and prosecution. In reviewing its legal framework, a country must check that existing criminal codes and civil service laws, conflict-of-interest statutes, and other regulations that apply to public servants are clear and consistent. A prominent effort is the implementation of the National Public Service Ethics Law in Japan, the country’s first such legislation in August 1999. This law basically bans public servants from receiving gifts and/or entertainment from private companies under their jurisdiction. Furthermore, senior officials in the central government are required to report gifts or entertainment worth more than 5,000 yen, with some in higher positions required to report their stock and income transactions as well. In Central Europe, Poland adopted a law requiring all public officials to declare their financial assets, property, and business capital, whereas Hungary introduced in 2001 a wide-ranging property declaration system for civil servants and adopted a specific act in 2003 on ensuring the transparency of public expenses.

1.7 Efficient Accountability and Control Mechanisms

Accountability and control mechanisms encourage ethical behavior by making unethical actions hard to accomplish and easy to detect. Accountability mechanisms set guidelines for government activities, for checking that results have been achieved, and for checking that due process has been observed. They include internal administrative procedures (requirements that activities or requests be recorded in writing), comprehensive processes such as audits and evaluations of an agency’s performance, or new forms of procedures such as whistleblowing—which can encourage public servants to expose wrongdoing committed by others or to say no when asked to do something inappropriate. They might also be external to the public service: for example, oversight mechanisms in the form of legislative or parliamentary committees.

1.8 Active Civil Society

Ethics and fighting corruption is everybody's responsibility, including that of an assertive media that through its investigative reporting helps to raise awareness among citizens and act as a watchdog over the actions of public officials. Freedom of information laws, now present in most developed democracies (most recently adopted in Mexico in 2002 and Switzerland in 2004) can institutionalize and support public awareness and responsiveness.

2. An Updated Framework: A Proactive Approach

The elements of the Ethics Infrastructure outlined above must be adapted to encompass developments as the public sector environment has evolved considerably in the last decade, both at the organizational level and in the wider public management and governance environment. To increase responsiveness in public service, new public management reforms have led to the devolution of responsibilities and increased commercialization of public services. However, reforms to make governments more efficient and effective have often fallen short of enhancing public trust.

One particular concern is that public management reforms have opened grey zones and opportunities in the absence of adjustments to control discretionary power. With the breaking down of barriers between public and private sectors—e.g., through the privatization of services—governments recognized that conflict of interest has become a key concern in public debates worldwide.

This proactive approach has progressively become a cornerstone for a modern government that looks ahead and addresses citizens' growing expectations. In particular, an emerging concern is to map out risks to integrity in order to strengthen corruption resistance in the public service. Governments have started developing additional measures for categories of officials that are particularly vulnerable to corruption. These include officials working at interfaces:

- With the private sector, in particular public procurement and contract management, sponsoring, public officials leaving the public sector to work for the private sector, etc.;
- With politicians, because of potential political interference; and
- With citizens, for example, law enforcement, tax administration, customs, etc.

Preventing corruption in the public service requires more than designing and implementing core integrity and anti-corruption standards. A culture of integrity in

the public service is the visible result of efforts at organizational, public management, and governance levels.

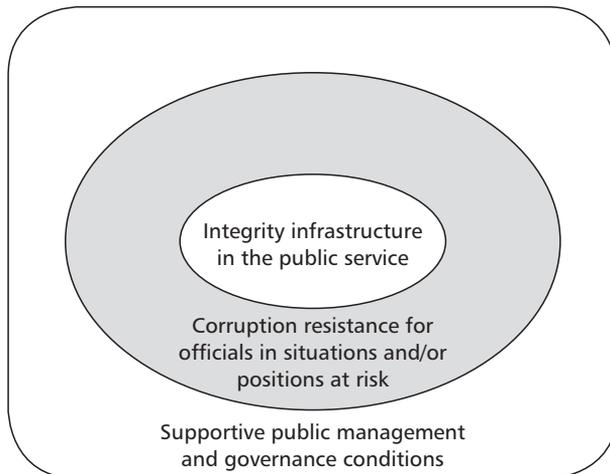
As part of a “whole-of-government approach” to modernize governments, there is growing recognition that the success of anti-corruption strategies also depends on the creation of a supportive environment in the public administration in which transparency and accountability play an essential role. For instance, control in public finance, administrative simplification, and e-government are essential components to a long-term strategy for enhancing resistance to corruption.

Furthermore, at the governance level the involvement of stakeholders such as elected officials, private sector actors, civil society, media, and the wider public is an essential condition for the successful development and implementation of pro-integrity and anti-corruption reforms.

3. Integrity Circles

An updated framework should take into consideration the lessons learned in reforming pro-integrity and anti-corruption measures in the past decade. Annex 1 at the end of this chapter outlines this shift by giving details on the elements of three interrelated Integrity Circles (see Figure 2).

Figure 2.
An Inside-out View of Government Pro-integrity and Anti-corruption Efforts
Integrity Circles



The core part of the **first circle is the integrity infrastructure** that identifies appropriate legal, institutional, and procedural frameworks for setting and implementing values, principles, and standards of conduct for the public service to embed a culture of integrity and corruption prevention. Within this infrastructure five strategic goals are identified, each supported by a set of complementary mechanisms:

- *Setting standards*—i.e., through an updated set of values, principles, and standards—is critical to make clear what is expected from public officials in daily conduct. This objective can be institutionally supported by mission statements, codes of conduct, and anti-corruption and conflict-of-interest legislation. A consultative process with stakeholders for defining values and standards can result in higher awareness of standards and they more adequately reflect expectations of society and business.
- *Providing guidance* through communication, training, role models, and counseling will further promote a lasting culture of integrity and corruption prevention. This includes leading by example on the part of senior officials, communicating expectations regarding ethical conduct, and capacity building and counseling for resolving integrity dilemmas in the work place.
- *Monitoring* also plays an important role for verifying compliance with values and standards to identify deficiencies and improve management. This requires regular organization and follow up of controls (e.g., financial management control, internal audit, etc). Facilitating the reporting of misconduct via accessible procedures for reporting and adequate protection of whistleblowers also helps monitor misconduct and possibly corruption. Finally, scrutiny over public sector operations—by independent bodies such as courts of audit, ombudsmen, or parliamentary committees—contributes to integrity and accountability in the public service.
- Once standards are established, *enforcement* is key to ensuring they become part of the integrity culture. This requires, for instance, clear descriptions of disciplinary rules, guarantees for equal treatment, and appropriate legal and financial means for investigation and prosecution.
- Finally, *integrity in daily management* must be fostered through adequate incentives, in particular merit-based selection, promotion, and remuneration. Performance targets can also be employed like integrity considerations can be integrated in recruitment and performance assessment.

Encompassing the integrity infrastructure, the **second circle enhances corruption resistance**, where risks to integrity are anticipated and corruption resistance efforts should be developed to maintain public trust:

- *Assessing the main risks* to integrity by mapping situations and positions of vulnerability—in particular at the public/private sector interface (e.g., public procurement, contract management, public-private partnerships [PPPs]); the political/administrative interface (e.g., political advisers); and the government/citizen interface—is a primary instrument for building corruption resistance.
- *Applying specific measures* that are adequately tailored to the type of risk (e.g., additional guidelines, restrictions, requirements, tightened control, background checks for certain positions, regularly rotating personnel, etc.) is also essential for building corruption resistance in public organizations.

Supportive public management and governance conditions are essential for implementing integrity and corruption resistance efforts in a coherent manner. These conditions include:

- *Overall coordination* of pro-integrity and anti-corruption efforts through articulated policy measures to ensure their consistency and integration in daily management in order to improve overall performance (e.g., by enhanced transparency and accountability in accounting and public finance).
- *Ensuring that the wider public governance and management contexts*—in particular enhanced transparency and accountability measures, political, economic, and social drivers of corruption—are properly identified to enhance corruption resistance and support integrity and overall performance.
- *Involving stakeholders* like the private sector, the media, and the wider public who have a strong role to play as drivers for cultural change. This requires the education of stakeholders to raise awareness about integrity, as well as the involvement of civil society and the public at large in public decision-making through information, consultation, and direct participation (e.g., monitoring).
- Finally, the *impact of reform implementation must be assessed* in order to provide relevant and credible information for policymakers and the general public. Data collection methodologies and systems focused on measuring the impact of integrity programs, followed by establishing procedures that properly integrate the collected data into a policy cycle, are means to achieve this objective.

The updated framework for integrity and corruption prevention in the public service provides a practical instrument to verify whether vital building blocks are in place in public organizations to enhance integrity and corruption resistance and to assess whether these efforts lead to expected results. It describes in particular:

- What specific objectives public officials may follow to enhance integrity and corruption prevention;
- What mechanisms/building blocks they have in hand; and

- Examples of qualitative assessments that illustrate the dimensions that governments could integrate when measuring the achieved results.

These examples of qualitative assessment comprise the verification of the existence of standards/mechanisms as well as their effectiveness and impact on the culture of public organizations (e.g., whether public officials are aware of standards, understand them, and are committed to act accordingly; whether mechanisms to prevent corruption are available and are actually used, etc.).

The approach taken by the framework is an inside-out vision of how to enhance integrity and corruption prevention from the perspective of public organizations. It starts with measures that specifically aim at promoting integrity in public organizations, and for which public officials have a direct capacity and responsibility to act. Public officials are considered as the primary actors for “sowing the seeds” of integrity in the public service and for partnering with other stakeholders.

4. Measuring Integrity: Indicators and Benchmarks

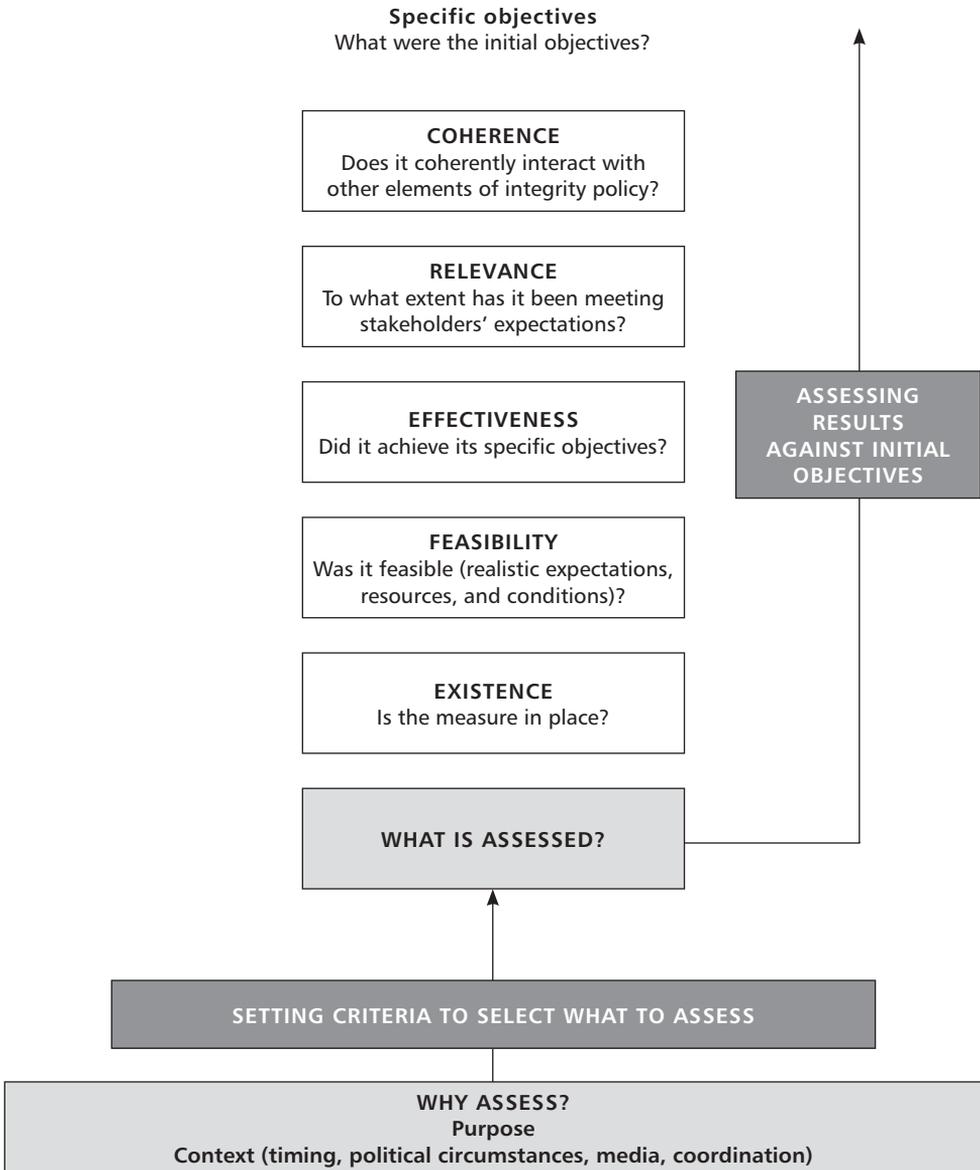
4.1 Challenges and Approaches to Provide Credible Data on Implementation and Impact

Countries have in the last decade made substantial efforts to develop institutions, systems, and mechanisms for promoting integrity and fighting corruption in the public service. A growing demand for evidence of impact requires public institutions to shift their focus towards verifying the effectiveness of these efforts.

Advocacy groups have used perception indices in order to raise awareness of the issue of corruption at the political level and in society at large. Indices such as the Corruption Perceptions Index and the Bribe Payers Index developed by Transparency International have been extensively cited in the media worldwide. Yet their methodology has been contested; these indices are often quoted as international benchmarks although they give little indication of where the risks for corruption lie or whether progress has been made in a number of key areas.

Good governance requires thorough assessment, and policies promoting integrity and preventing corruption are no exception. Assessment is a crucial way for governments to provide evidence-based information on the results of their efforts to fight corruption. Governments are increasingly expected to verify whether integrity policies are achieving their objectives in order to foster a favorable economic, political and social environment and strengthen public trust. However, assessment in this field raises specific challenges, in particular the definition of an objective methodology.

Figure 3.
Setting Criteria Assessing Integrity and Corruption Prevention Policy Measures



Source: OECD. 2005. *Public Sector Integrity: A Framework for Assessment*.

4.2 Designing the Assessment Process: OECD Assessment Framework

4.2.1 Challenge One: What to Measure?

The OECD Assessment Framework (OECD 2005) provides a set of criteria to help decision-makers and managers design an assessment that captures relevant information for decision-making. Assessments may focus on:

- Formal existence of measures—are integrity policy instruments (e.g., legal provisions, codes of conduct, institutions, procedures) in place?
- Feasibility—are integrity policy instruments capable of functioning?
- Effectiveness—did the integrity policy instrument achieve its specific initial objectives?
- Relevance—how significantly have policy instruments contributed to meeting stakeholders' overall expectations (e.g., overall impact on daily behavior)?
- Coherence—do the various elements of the procedure coherently interact and reinforce one another, and support the overall aims of integrity policy?

4.2.2 Challenge Two: How to Ensure Reliability?

The reliability and credibility of the assessment will depend on both the procedures for conducting an assessment and the methodology developed. Weighing the advantages of internal and external assessment will help determine who will actually conduct the assessment. In order to ensure the credibility and reliability of the findings, several factors need to be considered, in particular:

- Impartiality of the assessor and its competence;
- The need for directly using findings in the decision-making process;
- Time, resources, and internal capacities available to conduct the assessment;
- Involving external stakeholders that could support wider acceptance of evaluation outcomes;
- Identifying relevant observable measures that reflect not only the outputs—i.e., the immediate results of a policy—but also its outcomes—i.e., benefits in participants' knowledge, attitudes, and behaviors achieved by the policy.

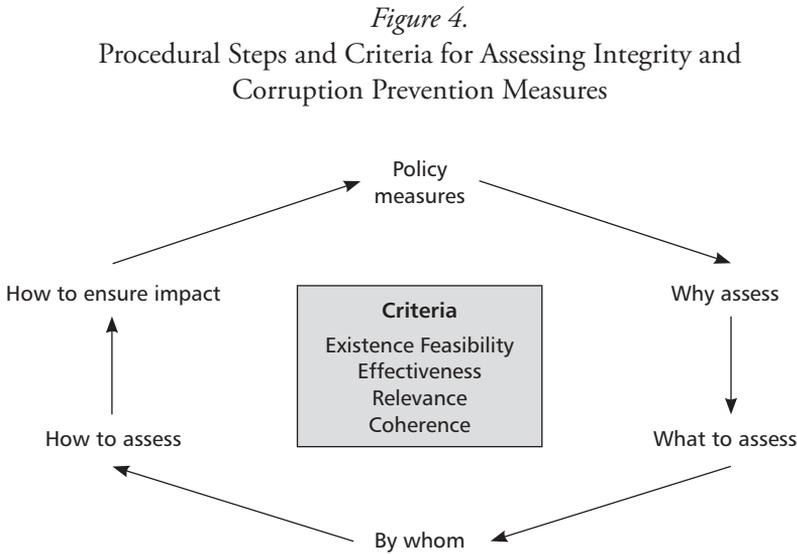
It is much easier to measure the number of training sessions provided on a code of conduct than to assess whether public officials are aware of the standards and values outlined in the code, as well as being able to properly identify ethical dilemmas and being committed to solve them according to stated standards.

4.2.3 Challenge Three: How to Ensure Impact?

If reaching credible and useful conclusions may seem like an end in itself, it is similarly important to ensure that:

- Assessment results are properly communicated to policymakers in charge of formulating and implementing a policy and actually used in the policy cycle.
- Active follow-up actions, such as mandatory responses from examined organizations or follow-up reviews and trainings using the results of assessment.
- Findings are also communicated to a wider audience such as stakeholders and society at large to foster accountability.

The following figure presents procedural steps and criteria for assessing integrity and corruption prevention measures.



Source: OECD. 2005. *Public Sector Integrity: A Framework for Assessment*.

4.3 Data and Indicators—Measuring Processes, Outputs, and Outcomes

Most efforts so far to measure corruption have relied on perception indicators¹ whose validity and appropriateness for tracking change are open to considerable debate. As Michael Johnston highlights (2007), national-level corruption indices have become increasingly sophisticated but significant problems remain:

- Starting with the basic issue of definitions: consensus on a nominal definition of corruption likely will never be reached.
- Most existing indices can do little to track trends over time because of irregular underlying data and contrasting methods.
- “The single-number problem” which hides differing types of corruption occurring in different segments of societies and governments.
- Knowing that corruption is extensive does not, by itself, tell us what to change and what to leave alone. Corruption, even where it is severe, does not explain all that goes wrong in a government or society (e.g., policies may be poorly conceived and under-funded).

Rather than attempting to measure corruption itself, an emerging approach is to use the indicators of government performance to track trends in the effects of corruption, and in the incentives sustaining it. The notion of actionable indicators requires that as much data as possible must directly reflect aspects of governance over which we have significant amounts control—specific processes, problems, and trends about which leaders and reform advocates can do something. It follows that the notion of indicators must track changes in sensitive and accurate ways, not only giving reform leaders invaluable feedback on the effects of their efforts, but also enabling them to take credit for success or progress, or fixing accountability for failure.

An example of such indicator is bureaucratic burden: in City A getting a building permit involves 33 steps and takes seven weeks, while in City B the same process typically involves four steps and takes three days. Corruption cannot be measured in those two agencies directly; however, theory and anecdotal evidence suggest that the numerous steps and long delays in City A are both effects of corruption (bureaucrats have found they can make money by contriving new requirements and delays) and incentives sustaining it (construction firms, knowing that time is money and facing numerous bureaucratic “toll gates” and long delays, find it quicker and cheaper to pay up).

Similar indicators could be easily gathered, and clearly linked to the effects of corruption and to its sustaining incentives, comparable from one place and time to another, and easily understood by citizens and non-specialists. Further examples might include:

- Time, expense, and the number of steps involved in establishing a small business or a corporation; similarly, the frequency and cost of hiring consultants.
- Speed and accuracy with which vendors’ invoices are paid.
- Time and charges involved in obtaining routine information, copies of documents, or more specific sorts of services such as passports, licenses, and permits.
- Time, number of steps, and frequency and range of variations involved in tax assessments and other revenue collections.

- Citizen assessments of the quality and responsiveness of public services.
- Trends in the numbers of licenses, permits, and in subsidy or benefit payments granted by a given agency.
- Number of inspections performed per member of field staff in regulatory agencies.
- Prices paid to suppliers and charged from the public for basic services (school meals, telephone equipment).
- Prices paid for fuel and basic clerical supplies.
- Prices paid for basic commodities involved in a public service (asphalt, concrete, vehicles, and tools).

Annex 2—based on (Johnston 2007) —provides more details on potential indicators, including their effects of past corruption and incentives to further corruption as well as possible benchmarks and actions indicated.

5. The Role of International Organizations

Sharing experiences of lessons learned in fighting corruption is a critical role for international organizations. The OECD has been an international leader in forging alliances and building networks that encompass transition economies, developing countries, and emerging markets from all regions of the world:

- In Central and Eastern Europe, the Caucasus, and Central Asia, progress in fighting corruption is being made in the framework of both the Anti-Corruption Network for Transition Economies (launched in 1998 in Istanbul) and a joint initiative of the OECD and the European Union named Support for Improvement in Governance and Management (SIGMA).
- In the Asia-Pacific region efforts to combat corruption are promoted and supported by the Asian Development Bank/OECD Anti-Corruption Initiative for Asia-Pacific that was launched in 1999 in Manila.
- More recently, the OECD launched a structured policy dialogue with Middle Eastern and North African (MENA) countries on issues related to corruption and public and private sector integrity. Within the framework of the MENA OECD Initiative on Governance and Investment for Development, MENA countries launched a Working Group on Civil Service and Integrity and a Task Force on Business Integrity and Bribery in 2005.

- In Latin America the OECD cooperates with the Organization of American States to support efforts of anti-corruption, state modernization, and good governance in Latin American countries.

International organizations also provide fora to develop and negotiate international standards. Anti-corruption conventions include:

- The *Inter-American Convention against Corruption* that was concluded in 1996 by the Organization of American States.
- The 1997 *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*.
- The 1999 *Criminal Law Convention on Corruption* of the Council of Europe.
- 2004 *United Nations Convention against Corruption* (UNCAC) that entered into force a combination of binding rules and prevention mechanisms for addressing corruption.

In addition to binding convention, international organizations also develop good practices and work out standards for preventing corruption and promoting integrity in public service. In order to prevent corruption and strengthen public trust in government, OECD countries are committed to review regularly and modernize their integrity policies and practices by:

- The 1998 *Recommendation on Improving Ethical Conduct in the Public Service*.
- The 2003 *Recommendation on Guidelines for Managing Conflict of Interest in the Public Service*.

Fighting corruption, promoting transparency, and improving integrity are also key objectives in the development of cooperation policies as corruption directly impedes progress towards the common poverty reduction and the Millennium Development Goals. OECD countries include the major donors that first introduced anti-corruption provisions in their work in procurement agreements funded through bilateral development aid, following the 1996 Recommendation on Anti-Corruption Proposals for Aid-Funded Procurement. In 2003, donors set out to work together closely to ensure that they collectively support country-led anti-corruption strategies and to ensure that aid programs themselves do not foster corruption, as detailed in the Development Assistance Committee's Principles for Donor Action in Anti-Corruption.

However, international government organizations are not the only players in the international arena; civil society organizations and the private sector also significantly contribute to the common aim of promoting integrity and fighting corruption. All of these actors are important part of the broad policy dialogue that underlies their respective roles and joint responsibilities to eradicate corrupt practices in all parts of the world.

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Note

- ¹ The most prominent indices include: Transparency International's Corruption Perceptions Index (CPI), Bribe Payers' Index, and Global Corruption Barometer.

Annex 1.

Elements for an Updated Framework for Integrity and Corruption Prevention in the Public Service

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
<p>CIRCLE I. — INTEGRITY INFRASTRUCTURE</p>			
<p>Embedding a culture of integrity in the public service and preventing corruption through a combination of legal, institutional, and procedural frameworks in the public service</p>			
<p>1.1 Setting standards</p>	<ul style="list-style-type: none"> ▪ Setting core values, principles, and standards for integrity and corruption resistance in the public service to clarify what is expected from public officials 	<ul style="list-style-type: none"> ▪ Statement of core values, principles, and standards (e.g., in the form of mission statement, code of conduct, anti-corruption, and conflict-of-interest legislation) ▪ Involvement of stakeholders in the definition of core values, principles, and standards in the public service (e.g., through consultation) 	<ul style="list-style-type: none"> ▪ Whether core values, principles, and standards are up-to-date to reflect expectations and cover emerging issues
<p>1.2 Providing guidance</p>	<ul style="list-style-type: none"> ▪ Providing guidance through role model, communication, training, and counseling to embed a culture of integrity 	<ul style="list-style-type: none"> ▪ Demonstration of personal example by senior officials (e.g., avoiding the exploitation of rules, taking proactive steps to avoid apparent conflict of interest) ▪ Communication of expectations of ethical conduct (e.g., communicating values, providing induction training and briefing, identifying vulnerable areas in organizations, punishing misconduct) ▪ Provision of counseling for resolving work-related integrity dilemmas (e.g., coaching and support, ensuring follow up on reports of integrity concerns) 	<ul style="list-style-type: none"> ▪ Whether the behavior of senior officials is consistent with integrity policies and reflects stakeholders' expectations ▪ Whether officials are aware of integrity standards, understand them, and are committed to follow them ▪ Whether public officials know where to seek advice, actually seek advice when needed, and follow it

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
1.2 Providing guidance <i>(continued)</i>		<ul style="list-style-type: none"> ▪ Capacity building for resolving work-related integrity dilemmas (e.g., organizing ongoing training on integrity on a regular basis, promoting open discussions on integrity issues) 	
1.3 Monitoring	<ul style="list-style-type: none"> ▪ Monitoring compliance through control mechanisms to detect deficiencies and improve overall management ▪ Facilitating the reporting of misconduct while protecting against retaliation to detect deficiencies and promote accountability ▪ Facilitating independent scrutiny over public sector operations to detect deficiencies and promote accountability 	<ul style="list-style-type: none"> ▪ Organization of internal controls (financial, management control, and internal audit) on a regular basis that are supported by follow-up mechanisms to implement and monitor recommended measures for improvement ▪ Availability and publicity of procedure(s) and obligations for public servants to report misconduct ▪ Availability and publicity of procedures and supporting institutions for the public to expose misconduct of public servants ▪ Availability of mechanisms to protect whistleblowers against retaliation ▪ Organization and publication of external audits on a regular basis that bring misconduct to the attention of bodies exercising independent scrutiny on public service activities (e.g. court of audit, ombudsman, parliamentary committee) 	<ul style="list-style-type: none"> ▪ Whether controls reduce opportunities for corruption and provide sufficient disincentives for misconduct ▪ Whether public servants are aware of the procedures to report misconduct, feel safe reporting, and actually report misconduct when witnessed

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
<p>1.4 Enforcing standards</p>	<ul style="list-style-type: none"> ▪ Ensuring enforcement through disciplinary procedures and sanctions that are dissuasive while ensuring fair treatment ▪ Ensuring the independence of investigative and prosecution bodies 	<ul style="list-style-type: none"> ▪ Description of disciplinary rules and sanctions (e.g., in legislation, agency documents) ▪ Existence of guarantees for equal treatment, in particular availability of legal redress ▪ Provision of adequate legal and financial means to investigation and prosecution (e.g., status and accountability of bodies, power to bring suspected cases of corruption directly to court, cooperation between bodies, and resources available) 	<ul style="list-style-type: none"> ▪ Whether disciplinary sanctions are applied in a consistent and proportionate manner ▪ Whether officials in the public service perceive that the sanctions applied are timely and dissuasive ▪ How often officials use legal redress
<p>1.5 Fostering integrity in daily management</p>	<ul style="list-style-type: none"> ▪ Providing adequate incentives for integrity in daily management through merit-based selection, promotion, and remuneration 	<ul style="list-style-type: none"> ▪ Design of open selection, promotion, and performance appraisal procedures ▪ Definition of criteria for selection and promotion ▪ Introduction of safeguards for senior public officials to ensure consideration of merit for appointment ▪ Provision of sufficient and fair remuneration ▪ Integration of ethics in recruitment and performance assessment ▪ Use of performance targets and evaluation in relation to career management 	<ul style="list-style-type: none"> ▪ Whether officials in public service are selected and promoted in a transparent manner ▪ Whether criteria for the selection, promotion, and performance appraisal are clear and used in a consistent manner

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
CIRCLE II. — CORRUPTION RESISTANCE IN THE PUBLIC SERVICE			
Anticipating risks to integrity and building corruption resistance of officials who are vulnerable to corruption in order to improve public trust			
2.1 Assessing the main risks to integrity	<ul style="list-style-type: none"> ▪ Assessing risks through the identification of situations and/or positions that are particularly vulnerable to corruption (risk areas) 	<p>Mapping out of situations and/or positions where officials are vulnerable to corruption, in particular:</p> <ul style="list-style-type: none"> ▪ at the interface with private sector (e.g., involved in public procurement, contract management, sponsorship; leaving the public sector to work in the private sector) ▪ at the political/administrative interface because of their level (e.g., public office holders) ▪ at the interface with citizens (e.g., working in law enforcement, tax administration, customs, etc.) 	<ul style="list-style-type: none"> ▪ Whether existing and emerging risks to integrity have been mapped out in the public service ▪ Whether public officials are aware of the main risks to integrity in relation to a situation and/or position in the administration

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
2.2 Building corruption resistance	<ul style="list-style-type: none"> ▪ Developing corruption resistance measures (e.g., specific guidelines and requirements) for officials working in risk areas 	<ul style="list-style-type: none"> ▪ Use of background check for certain positions and/or security-vetting ▪ Rotation of personnel on a regular basis ▪ Separation of duties and authorization (e.g., four-eyes principle) ▪ Development of specific standards (e.g., specific conflict-of-interest legislation, specific code of conduct for ministers and public office holders) ▪ Declaration of assets/ financial interests to prevent conflict of interest or detect illicit enrichment ▪ Stricter internal control or verification measures ▪ Specific training and briefing ▪ Direct social control to ensure public scrutiny on government process (e.g., in public procurement and contract management) 	<ul style="list-style-type: none"> ▪ Whether officials are carefully selected for positions that are vulnerable to corruption ▪ Whether officials in positions vulnerable to corruption are aware of corruption resistance measures and understand what is required of them ▪ Whether specific/ tightened controls reduce opportunities for corruption and provide sufficient disincentives for misconduct

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
CIRCLE III. — SUPPORTIVE PUBLIC MANAGEMENT AND GOVERNANCE CONDITIONS			
Ensuring the coherence of pro-integrity and anti-corruption measures in the administration and fostering a supporting public management and governance environment			
3.1 Ensuring overall coordination of pro-integrity and anti-corruption efforts in the government	<ul style="list-style-type: none"> ▪ Articulating policy measures to ensure consistency of pro-integrity and anti-corruption efforts 	<ul style="list-style-type: none"> ▪ Development of articulated pro-integrity and anti-corruption measures (e.g., in the form of a strategy and action plan, risk assessment) together with key stakeholders ▪ Coordination and management of the implementation of pro-integrity and anti-corruption measures (e.g., by a central agency) ▪ Provision of adequate powers and capacity for coordination (e.g., status and resources for a pro-integrity/anti-corruption agency) 	<ul style="list-style-type: none"> ▪ Whether pro-integrity and anti-corruption measures form a coherent and up-to-date framework that reflects stakeholders' expectations ▪ Whether pro-integrity and anti-corruption measures are implemented consistently across the administration
3.2 Ensuring that public management conditions support integrity and overall performance	<ul style="list-style-type: none"> ▪ Enhancing transparency and accountability in critical phases of the budget through the disclosure of relevant fiscal information in a timely and systematic manner ▪ Supporting a transparent and predictable decision-making process through simplified administrative procedures 	<ul style="list-style-type: none"> ▪ Statement of accounting policies accompanying all reports on the budget ▪ Organization of a dynamic system of internal financial controls on the budget, with reports containing a statement of responsibility ▪ Regular audit of the report by the Supreme Audit Institution ▪ Fiscal report subject to parliamentary and public scrutiny ▪ Use of government procedures to reduce administrative burdens (e.g., setting time limits for administrative decisions, simplification/ reduction of licensing) 	<ul style="list-style-type: none"> ▪ Whether internal controls, auditing and legislative oversight are well coordinated to fill in gaps and maximize the information produced on the budget ▪ Whether administrative procedures are simple, user-friendly, and minimize opportunities for misconduct

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
<p>3.2 Ensuring that public management conditions support integrity and overall performance <i>(continued)</i></p>		<ul style="list-style-type: none"> ▪ Measurement of administrative burdens on investors ▪ Use of new technologies, for instance, one-stop shops to enhance transparency and effectiveness in administrative procedures 	
<p>3.3 Assessing the wider governance context for pro-integrity and anti-corruption reforms</p>	<ul style="list-style-type: none"> ▪ Identifying the main political, economic, and social drivers for corruption in the country to understand context of reform ▪ Demonstrating commitment for reform by political leaders 	<ul style="list-style-type: none"> ▪ Assessment of risks through public trust surveys, anti-corruption assessments, feedback from stakeholders (e.g., public service users) ▪ Development of anti-corruption legal and institutional arrangements and provision of adequate powers and resources ▪ Development of legal and institutional arrangements for enhancing transparency and accountability in lobbying (e.g., registration) ▪ Enhancement of transparency and integrity in the election financing framework (e.g., disclosure requirements, restrictions for donations) ▪ Development of legal and institutional arrangements to limit the degree of media concentration and encourage diversity of ownership ▪ Limitations on investigations and prosecutions of public office holders (e.g., through immunity) 	<ul style="list-style-type: none"> ▪ Whether main drivers of corruption have been mapped out in the country ▪ Whether anti-corruption legal and institutional arrangements cover emerging risks and are properly functioning ▪ Whether investigations and prosecutions of public office holders are excessively constrained by immunities

CIRCLES	OBJECTIVES	BUILDING BLOCKS/ MECHANISMS	EXAMPLES OF QUALITATIVE ASSESSMENTS
3.3 Assessing the wider governance context for pro-integrity and anti-corruption reforms <i>(continued)</i>	<ul style="list-style-type: none"> ▪ Ensuring that media, civil society, the private sector, and the wider public are drivers for cultural change 	<ul style="list-style-type: none"> ▪ Information, consultation, and active participation of citizens (e.g., legislative and administrative framework on access to government information) ▪ Direct and indirect public scrutiny over government processes (e.g., role of parliament, involvement of NGOs, and other watchdogs) ▪ Education on ethics to the private sector and the wider public (e.g., specific curricula) 	<ul style="list-style-type: none"> ▪ Whether there is a freedom of information legislation guaranteeing access to government information

Annex 2.

Possible Indicators and Benchmarks*

Indicator	Effects of past corruption	Incentives to further corruption	Possible benchmarks	Actions indicated
Citizen assessments of public services and quality of inspected businesses	Poor quality services and/or low levels of satisfaction: graft, theft, kickbacks, favoritism; bid-rigging and other tendering problems; weak accountability and oversight of agents; theft of time, moonlighting	Persistently poor quality in services encourages citizens to pay for services to which they are entitled, weakens expectations of performance and accountability, creates incentives for black-market provision (often involving government workers and materials)	Levels of satisfaction can be regularly assessed via household, business surveys, "Citizen Report Cards," and related consultation	Build citizen evaluations into agency routines; follow-up surveys with consultation between citizens and agencies, managers; reward agencies and leaders winning high marks
Time, steps, fees involved in registering a business	Too slow, elaborate, official fees too high: extortion, bribery, official collusion with business competitors Too fast or variable: favoritism, bribery, non-enforcement of policy	Too slow, official fees too high: opportunity to demand bribes, reasons to pay, exposure to officially-favored competitors, "consultants" Too fast or variable: favoritism, unfair business competition, links to bid-rigging	Case handling in other jurisdictions: speed, costs, data/paperwork required, frequency and scope of variations, frequency of use of consultants	Review officials' monopoly power, discretion, accountability; enforce reasonable performance standards; gather info from clients; randomly audit cases; create client advocates

* Based on Michael Johnston. 2007. *Benchmarks for Integrity: Tracking trends in Governance*. Paris: OECD.

Indicator	Effects of past corruption	Incentives to further corruption	Possible benchmarks	Actions indicated
Speed and accuracy with which vendors' invoices are paid	Slow/inaccurate payment, underpayments: extortion of vendors, official theft Very rapid payment, overpayments: kickbacks, self-dealing, favoritism, "ghost vendors," substandard goods	Departures from reasonable norms allow kickbacks, theft, extortion; create cover for "ghost vendors" and self-dealing	Multi-agency and private-sector norms for speed, error rates; aiming at rising performance levels, and at published goals negotiated as appropriate with vendors	Real-time monitoring of procurement, payments; random auditing of tenders, contracts, provision, payment; solicit feedback from vendors
Amount or percentage of time spent by businesspeople in dealing with officials	Too much: bureaucratic harassment, foot-dragging, in pursuit of bribes; extortion Too little or wide variation: favoritism; bribery initiated by business	Too much: time lost, threat of fines and charges, and uncertainty increase incentive to pay Too little: bribe payments can reduce administrative overhead costs, delays, uncertainty	Typical amounts of time spent, by sector, as established by business surveys	Reducing administrative discretion; revise queuing arrangements and case loads to break up personal links between officials and business people; continued surveys of business; internal data-gathering on frequency, duration of interactions
Time, steps, charges involved in obtaining routine information, passports, or documents	Too slow, elaborate, expensive: extortion, bribery, lack of transparency Too fast or variable: favoritism, bribery, forgery, blackmail, sale of official/confidential data	Too slow, official fees too high: opportunity to demand bribes, reasons to pay Too fast or variable: payments to buy time, preserve confidentiality, avoid blackmail	Case handling in other jurisdictions: speed, fees, frequency, and scope of variations	Review officials' monopoly power, discretion, accountability; enforce standards for speed of handling cases; gather info from clients; random audits of cases; create client advocates

Indicator	Effects of past corruption	Incentives to further corruption	Possible benchmarks	Actions indicated
Time, steps, and frequency/scope of variation involved in tax assessments and other revenue collections	Too slow/elaborate: extortion, bribery Too fast, or excessive variation: favoritism, bribery	Too slow or too fast, variable: Taxpayers/property owners vulnerable to manipulation, and/or believe payments can win favorable treatment	Case handling in other jurisdictions: speed, frequency, and scope of variances	Review assessors and collectors' monopoly power, discretion, accountability; enforce standards for handling cases; gather info from clients; random audits of cases; create ombudsmen or citizen advocates; monitor assessments for frequent variances
Number, frequency, variation of routine inspections of businesses	Too many, too variable: extortion, often on-the-spot Too few, or low-quality: bribery over the longer term, favoritism, often involving supervisors	Too many, too variable: reasons to pay on the spot Too few or low-quality: reward for cultivating, participating in longer-term links with officials	Frequency and range of variation of inspections in other jurisdictions; frequency of citations or infractions; share of cases settled informally	Review internal accountability, inspectors' powers and discretion in the field; set reasonable performance targets and investigate divergences; gather information from businesses, customers
Trends in the numbers of subsidy or benefit payments granted by an agency	Too many: kickbacks, possibly shared with superiors; political pressures to distribute patronage Too few, or arbitrarily distributed: favoritism, possibly in response to political pressures	Too many: signal that bribes can obtain benefits, funds; voter fraud Too few, or arbitrarily distributed: political manipulation of agencies, citizens; problems with accountability, transparency	Patterns of benefit distribution in other jurisdictions	More specific legislation, rules for eligibility, benefits; audit successful and unsuccessful applications; review agencies' internal accountability, independence; establish citizen advocates

Indicator	Effects of past corruption	Incentives to further corruption	Possible benchmarks	Actions indicated
Number of inspections performed per member of field staff in regulatory agencies	Too many: extortion on small-medium scale Too few: corrupt pressures from supervisors, bribery/extortion on larger scale; theft of time, moonlighting	Too many, too variable: vulnerability to extortion, reasons to pay on the spot Too few: signal that supervisors will reward larger/longer-term payments	Number, and range of variation, of inspections per staff member in other jurisdictions; frequency of citations or infractions; share of cases settled informally	Review accountability within agencies, inspectors' powers and discretion in the field; set performance targets and investigate divergences; gather information from businesses, customers
Prices charged for basic services (school meals, telephone equipment)	High prices: graft/skimming/embezzlement Low/unusually variable prices: favoritism	Extra revenues finance graft Low/variable prices invite favoritism/side deals between clients and officials	Market prices for commodities, and median prices charged by other governments or agencies	Impose published price ceilings and floors, monitor client access, quality of provision, monitor revenue flows, tendering, and bidding
Prices paid for basic commodities involved in a public service (e.g., fuel, food, concrete, vehicles, tools)	High prices: kickback schemes Unusual variation: favoritism, nonstandard goods, breakdown of bidding	High prices finance kickbacks Variation invites exploitation of vendors, provision of substandard goods	Market prices for commodities, and median prices paid by other governments or agencies	Impose published price ceilings and floors, monitor quality of provision, monitor revenue flows, tendering, and bidding

Indicator	Effects of past corruption	Incentives to further corruption	Possible benchmarks	Actions indicated
Frequency and costs of outsourcing agency work to consultants	Too high: agency budget being diverted to politically connected “consultants”; consultants may operate as “middlemen” between agency and clients; agency employees may be devoting most effort elsewhere (shadow enterprises, political duties)	Too high: agency budget becoming a pool of “spoils,” spent with insufficient oversight; politically-favored but unskilled employees can be hidden on payroll as professional tasks are outsourced; political operators become “consultants”	Frequency, costs for consultants in comparable agencies in other jurisdictions; skill and training level workforce in those agencies	Restrict, increase oversight over, consultant hiring; invest in training agency’s own workforce, weeding out the unproductive; analyze budgets and outlays in proportion to tasks accomplished
Staffing levels in proportion to tasks accomplished	Too many employees: political interference converts payroll into a patronage pool; nepotism or communalism may have similar effects Too few employees: resources and workforce diverted to corrupt endeavors (an unlikely finding, if agency records conceal such practices) “Ghost workers”: people paid for work elsewhere or do not exist; payroll diverted by corrupt officials (difficult to show without comparing workforce records to actual tasks and accomplishments)	Too many: weak auditing, accountability allow payroll to be used for political, personal advantage; political interference a problem Too few: weak auditing, accountability allow payroll and resources to be diverted to private enterprises; “Ghost workers”: extremely weak controls allow theft of payroll; pervasive corruption likely to be sustained by involvement of top leaders and managers, and collusion with other officials	Compare workforce to similar agencies in other jurisdictions, or (if possible) to private-sector firms doing similar tasks; audit actual execution of tasks and use of resources to compare size of workforce to tasks accomplished, or to reveal “ghost worker” problems. Problems in this area, and “ghost worker” situations in particular, are likely to emerge as secondary findings based on analysis of other indicators and benchmarks	Tighten external oversight, internal auditing, and managerial/ workforce supervision; monitor “output” indicators of tasks accomplished and client satisfaction in light of resources and workforce employed; revise personnel practices at all levels

Indicator	Effects of past corruption	Incentives to further corruption	Possible benchmarks	Actions indicated
Budgetary levels in proportion to tasks accomplished	<p>Too high: funds are being diverted, wasted; excess or inefficient staffing reflects patronage</p> <p>Too low: funds are apportioned among agencies based on political loyalties of managers, or their potential as reservoirs of patronage; funds are being diverted to political uses, favored consultants</p>	<p>Too high: agency budget seen as political slush fund, or may be diverted by managers; patronage easily hidden, workforce poorly supervised</p> <p>Too low: funds are being diverted before reaching the agency</p>	<p>Funding levels in comparable agencies in other jurisdictions, assessed in proportion to agency activities and accomplishments</p>	<p>Tighter oversight of budgetary, personnel, supervision functions</p> <p>Set specific goals for agency accomplishments and move them upwards over time</p>
Supervisory/staff vs. line workforces	<p>Too many supervisors: agency has been colonized by elite families and their favorites</p> <p>Supervisory payroll too large: payroll has become an elite slush fund; funds may be diverted to shadow enterprises and corrupt deals</p> <p>Too many line employees: payroll has become a patronage pool for unskilled political loyalists</p>	<p>Too many supervisors: payroll accessible to abuse by top managers, political elites</p> <p>Supervisory payroll too large: funds available for theft, diversion into shadow enterprises</p> <p>Too many line employees: patronage likely to continue; line employees likely to be underpaid, and thus to demand payments from citizens</p>	<p>Examine the size of staff and line workforces in comparable agencies, particularly in other jurisdictions; relative size of each, in proportion to the other, an important indicator; examine size of supervisory payroll in comparison to agency tasks and accomplishments; gather data on citizen satisfaction levels, where appropriate</p>	<p>Tighten auditing and internal accountability measures; bring proportions and size of workforces and payroll toward multi-agency norms; examine personnel processes (hiring, review) and day-to-day supervision arrangements</p>

Fiscal Transparency in the
Formulation, Implementation, and
Auditing of Government Budgets

Albert van Zyl

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A b s t r a c t

Fiscal transparency has become one of the articles of faith in government budgeting. While fiscal transparency is widely accepted, it is seldom very clearly defined. For this reason this chapter starts with some conceptual clarifications related to this concept. In the rest of the chapter we look in more detail at what the specific decisions and actions are that government takes in producing an executing a budget, and what information is needed to hold government to account for these actions and decisions. The mere production of this information is, however, not sufficient to assure the usefulness of this information. The chapter later reveals some of the qualities of budget information that makes it useful for accountability purposes. Finally, the chapter analyzes some of the results of the 2006 Open Budget Index to see how transparent are a selection of 59 countries in the world.

1. Introduction

Fiscal transparency has become one of the articles of faith for everyone involved in government budgeting in whatever way. It is very difficult to find anyone that is prepared to argue against it.

Premchand (2001) argues that there are three major factors that have contributed to the exalted status of fiscal transparency in recent years.

First, since the mid-1990s there has been a growing awareness of the limits of enforcement mechanisms in accountability relationships. As a result, especially donor agencies have progressively emphasized the development of “answerability” relationships. This, in turn, has led to a growing emphasis on the role of civil society in demanding accountability. The strengthening of civil society, however, requires greater transparency in governmental actions.

Second, especially since the Second World War, governments have grown enormously in size and in the range of tasks undertaken. Most governments, however, are perceived to be failing in this task in one way or another. This erosion of trust in government and political leadership has spread across the developing and developed world. The demand for fiscal transparency is a response to this sense of disappointment. People want more information about what governments do because they no longer trust them.

The above refers to what Heald (2003) calls the “fiscal visions of the state” that often underlie the view that people take of fiscal transparency. A more favorable view of the state may see government as a protector against expenditure and tax lobbies. Some limitations of transparency may then be justified to protect government’s ability to play this protector role. More negative visions of the state may be very skeptical about such limitations in transparency. If the state is composed of corrupt officials and self-interested bureaucrats, then it is in the interest of citizens to expose their dealings to the light of day. However, it is safe to say that in most countries the public perception of government leans towards mistrust, hence the growing demand for transparency.

Third, the series of financial crises experienced during the 1990s confirmed the linkages in the global financial architecture. It has also become clear that governments no longer control their fiscal destinies and are largely dependent on how their fiscal management is perceived. In order to manage these perceptions, governments have been encouraged to be as transparent as possible about both their current fiscal status as well as their future fiscal intentions. As Potter (1999) puts it:

In fiscal policy perhaps nothing matters quite so much these days as what the financial markets think you are doing and how well you are doing it, and to add to the financial markets I think you increasingly have to take into account the fact that the donors like to know what it is that a country is doing and how well it is doing it.

The effort to manage the perception of future intentions in particular has spawned a range of new tools such as medium-term expenditure frameworks and pre-budget statements.

While fiscal transparency is widely accepted, it is seldom very clearly defined. One of the more comprehensive definitions is provided by Kopits and Craig (1998: 1):

Fiscal transparency is defined... as openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities... so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications.

This definition underlines that fiscal transparency is not just about current public sector accounts, but also about government's fiscal intentions for the future. Although Kopits and Craig do not mention this, it could be argued that past accounts are equally important.

In addition, government structure and functions are central to transparency. One of the reasons for this is the close link between transparency and accountability. So while the budget figures can tell us what the state of fiscal affairs is, they alone cannot tell us who is responsible for the decisions that produced this state of affairs. It is only when we know who made these decisions that fiscal information becomes useful for accountability purposes. For this we need to know what the government structure and the assignment of functions and responsibilities are.

We should also distinguish between *de jure* and *de facto* transparency arrangements. Financial and budgetary laws and regulations are probably amongst the least respected of all. So even where legislation may, for example, specify that audit reports should be released within six months of the end of the financial year or that government should include performance targets in its budget proposals, such legislation is often not respected in practice. So if one is interested in transparency for accountability reasons, it is far more important to know what the actual government fiscal practice is on a specific issue than what is legislated for.

The link between transparency and accountability also signifies that transparency is about more than the production of books and information. As Heald (2006) puts it: in order for transparency to be effective, there must be actors capable of processing, digesting, and using the information. So transparency is not just about what government chooses to show of its transactions, but also about who is watching these transactions and what they do about it.

While transparency is widely valued one could argue against it having absolute value. As Heald (2003) argues: more transparency trades off the value of sunlight with the danger of over-exposure. There is a strong case to be made that there are stages of government financial processes that should not be made public at specific times. One often-cited example is where government subjects a tax or tax provision to review. If the private sector were to become aware of this, they could base their investment decisions

on the mere fact that a tax is being reviewed. And these investment decisions could ironically itself bias the outcome of government's review. Other obviously sensitive areas would include plans for debt transactions, privatization decisions, exchange-rate policies, etc. This does not mean that parliament should not review and decide on the executive's eventual proposal that derives from such a review. Or that government as whole should not be held accountable for the decision that eventually made.

One of the ways of navigating through these difficult definitional issues is to follow Heald's distinction between event and process transparency. This means that government should be completely transparent about its inputs, outputs, and outcomes, but not necessarily about the processes that produce these inputs, outputs, and outcomes.

As we will show below, though, very few governments run a real risk of producing too much information. It is more often the case that governments produce but neglect to publish fairly innocuous information.

A lot of analytical and empirical work has been done that measures the level of transparency in countries and speaks to what would be made possible by greater transparency. We know a lot less about what factors drive governments to being more fiscally transparent. One exception is the groundbreaking work of Alt, Lassen, and Rose (2006) who found that both politics and fiscal policy outcomes influence the level of transparency. They found that more equal political competition and power sharing are associated with both greater levels of fiscal transparency and increases in fiscal transparency. Much, however, remains to be done before we know what the role of parliament, the media, civil society, and investor perceptions are in producing greater fiscal transparency.

In what follows we will look in more detail at what the specific decisions and actions that government takes in producing and executing a budget (section 2). In section 3, we look at what information is needed to hold government to account for these actions and decisions. The mere production of this information however is not sufficient to assure the usefulness of this information. So in section 4, we look at some of the qualities of budget information that makes it useful for accountability purposes. Finally, in section 5 we look at some of the results of the 2006 Open Budget Index to see how transparent 59 countries in the world actually are.

2. What Actions and Decisions Do Governments Take in the Formulation, Implementation, and Audit of a Budget?¹

Before we know what information to demand to make government fiscally transparent, we need to know what decisions and actions government performs during the budget process. In what follows we describe the skeleton of a generic budget process. Naturally, each country and each level of government (central, local, or regional) will have its own variations of the process described below.

The term “budget” is often mistakenly taken to refer only to government’s spending plans. Government’s intended spending plans are only one part of the process that determines what government spends and where it spends it. The executive’s budget proposal only marks the end of the formulation phase of the budget process. After this it is the turn of the legislature to amend and/or approve the budget and pass it into legislation. This phase of the budget process comes to an end when the finance act is passed that codifies the budget into law.

The budget execution phase of the budget process starts when funds are transferred to ministries, departments, and agencies (MDAs) on the budget of the finance act. During this phase government spends the budget to pay salaries, provide services, etc., as provided for in the approved budget. This phase of the budget process comes to an end when the financial year comes to an end and the relevant MDAs close their accounts.

The audit phase of the budget process starts when government accounts for the financial year are submitted to the supreme audit institution for auditing. This phase of the budget process ends when the supreme audit institution (SAI) submits its report to the legislature and the legislature taken any actions that may be necessary to conclude the budgeting cycle.

In the rest of this section we discuss each of these phases of the budget process in greater detail.

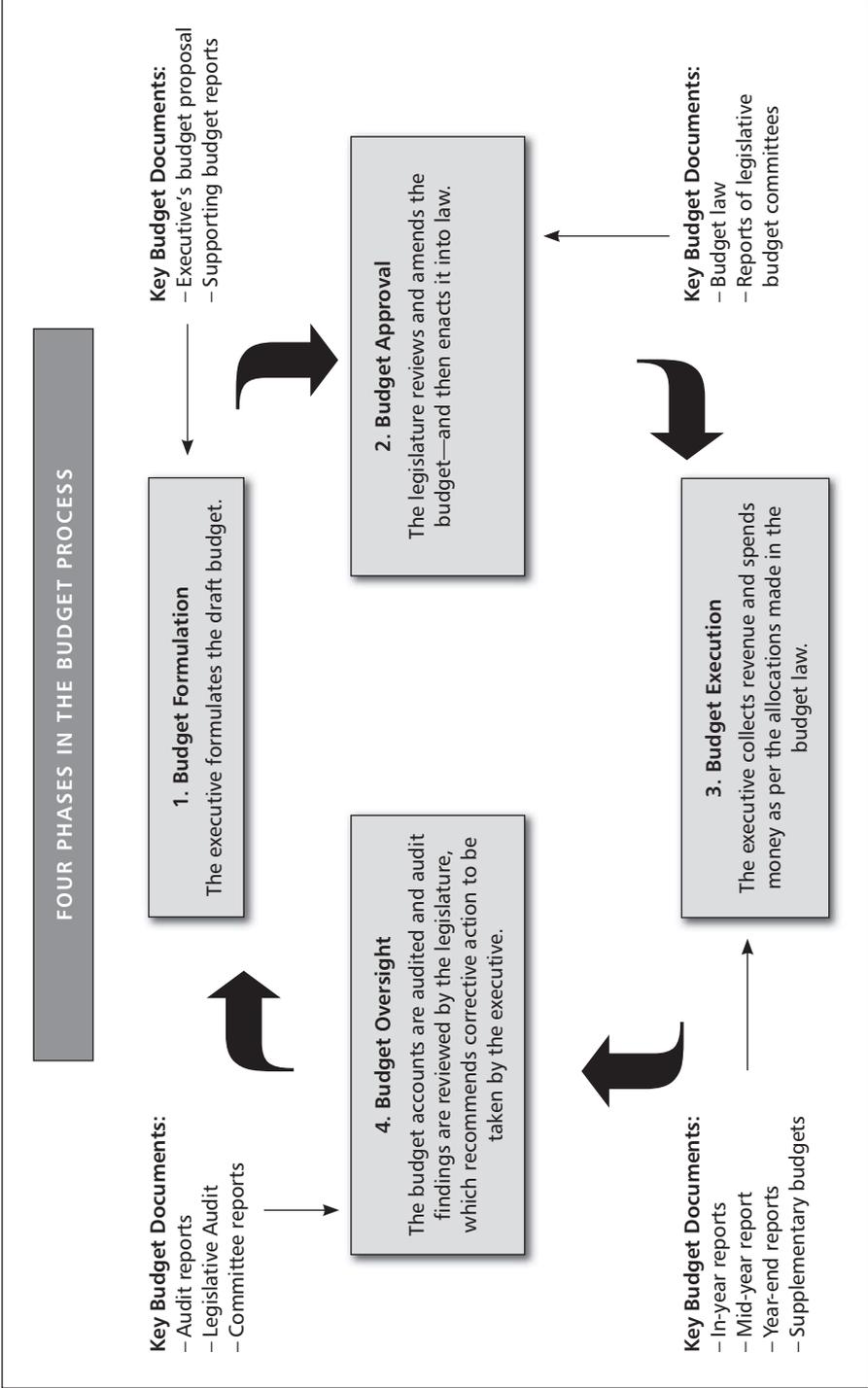
2.1 Budget Formulation

The budget process is initiated when the Ministry of Finance, the Central Bank, and sometimes donors and representatives from the Head of State (president or prime minister) decide on the fiscal framework within which the budget will be formulated. The fiscal framework typically determines overall levels of expenditure and revenue as well as the resultant budget deficit and borrowing requirements. In order to project the overall levels of revenue, the Ministry of Finance and the Central Bank must also determine any changes in the levels or composition of taxes. In some cases the document in which the fiscal framework appears (pre-budget statement or budget circular) also includes government’s broad expenditure priorities for the relevant financial year(s).

The next step in the budget formulation process is for the Ministry of Finance and the Cabinet or Council of Ministers to determine the overall indicative amount of money to be allocated to each government function or MDA.

Once these levels have been determined, MDAs are asked to formulate their individual budgets within these budget ceilings. Within each of these units of government, trade-offs between programs and activities will be made before the relevant

Figure 1.
The Budget Process



accounting officer and the political head of the MDA decide on the composition of its budget.

Within each of the programs that make up the budget of the relevant MDA, the relevant program head will decide how the money allocated to that program is to be divided up into specific activities.

Once these MDA details have been decided on, each such budget proposal typically is sent to the Ministry of Finance which consolidates the spending proposals and submits it to the Cabinet or Council of Ministers for final approval before the Minister of Finance (or the Head of State in some cases) tables the executive's budget proposal in the legislature.

2.2 Legislative Phase

The legislative stage of the budget process starts when the Executive's budget proposal is tabled in the legislature. The plenary of the legislature typically refers the draft budget to its Finance Committee for consideration.

The Finance Committee holds a series of hearings with the political and administrative heads of each of the MDAs, during which time their budgets are examined and potential amendments formulated.

Sometimes a Finance Committee would refer individual MDA budgets to specialist committees who would examine the relevant budget and refer recommendations and amendments back to the Finance Committee who would consolidate all of these into a coherent set of proposals that would go back to the plenary.

It should be noted that while the executive tables its entire set of revenue and expenditure proposals in the legislature, it is generally a very abbreviated version of its proposals that is reflected in the Finance Bill. And it is only the Finance Bill that is finally voted into law, not the entire revenue and expenditure proposal.

It should also be noted that the nature and the extent of the amendments that the legislature can make to the Finance Bill is generally limited. In many cases legislatures may not increase the overall size of the deficit. This means that where it wants to increase a specific expenditure item, it needs to propose a cut to another or else propose an increase on the revenue side that would fund this increased expenditure.

Once the Finance Committee has finalized its recommendations and proposed amendments, it refers these to the plenary where amendments are voted on and the resultant Finance Bill voted into law. The legislative phase of the budget process comes to an end once the Bill is voted.

2.3 Implementation Phase

The budget implementation phase of the budget process starts when funding is released to the relevant Ministry, Department, or Agency (MDA). Such a release can only take place once the budget has been passed into law by the legislature. These transfers also are made by means of formal warrants that authorize them legally and which may specify the line items against which the MDA may incur expenditure. Such specifications are derived from the enacted budget.

These transfers to MDAs are generally released in quarterly or even monthly payments from a central revenue fund. In Commonwealth countries this account is known as the Consolidated Fund. This account is often held with the Central Bank, but can also be held with commercial banks.

Spending is initiated

After funding is released to MDAs, program officers initiate spending proposals in terms of their budgets and areas of competence. These proposals are subject to review by the Chief Accounting Officer or his or her delegated official (often the Chief Financial Officer) of the same MDA to ensure that the proposed expenditure falls within the provision of the approved budget, that the decision to commit funds has been taken at the appropriate level of delegated authority, and that where relevant, government procurement procedures have been followed (Fozzard and Foster 2000). Once approved by the accounting officer, the MDA signs a contract or places an order for the delivery of goods and services.

Next the goods or services are delivered and the supplier or contractor presents the MDA with an invoice for the goods and services delivered. The department which initiated the order confirms that the goods or services were received, in compliance with the terms and conditions, and requests that the accounts department makes payment.

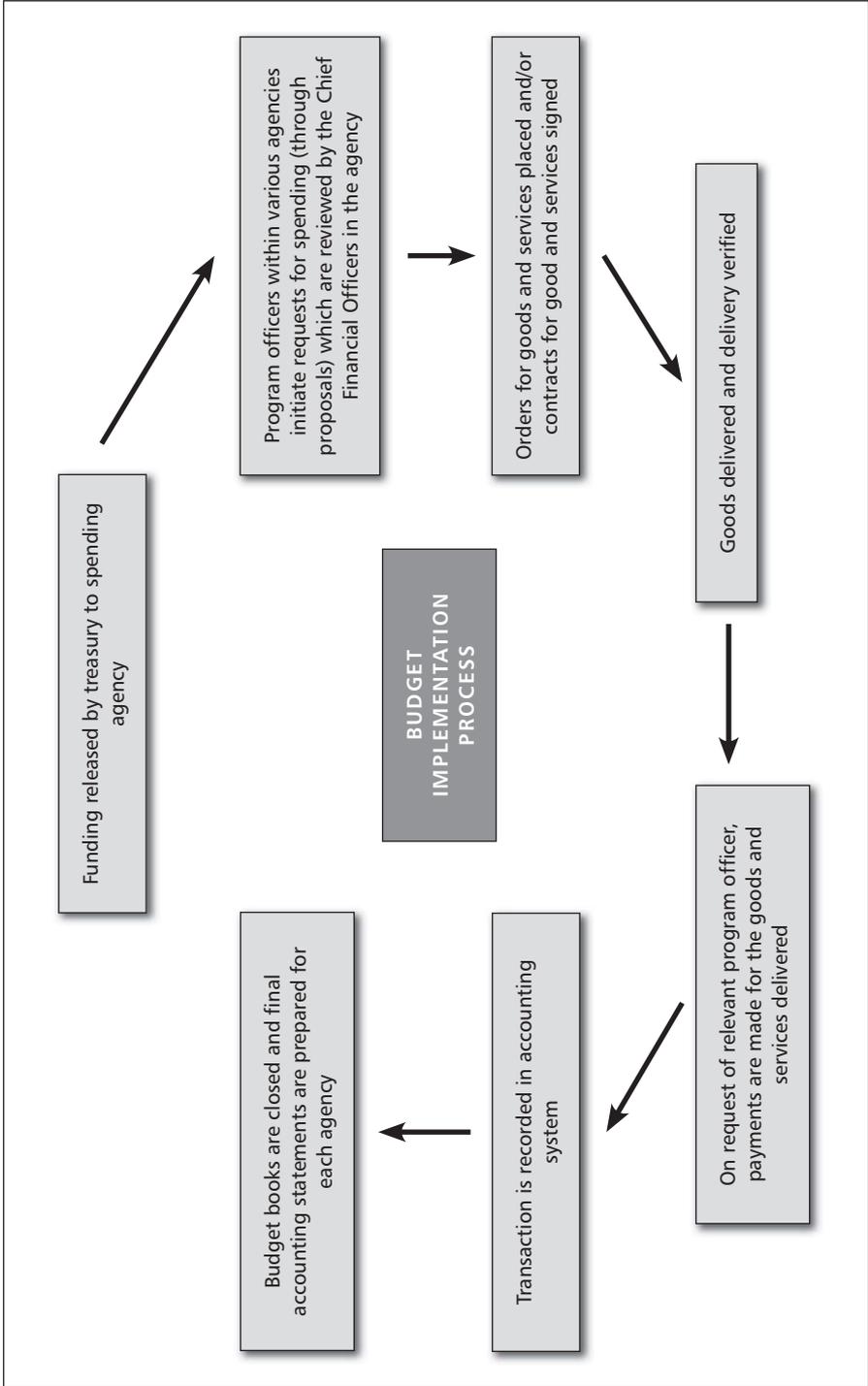
Payment is made

Payment is made by the accounts department of the MDA by check or bank transfer. This may vary in some countries where all payments are made by the Central Treasury. In many Francophone countries the person making the payment (“*le comptable*”) is legally protected against undue influence from the person making the decision to spend (“*l’ordonnateur*”).

Transaction is recorded

The transaction is registered as complete in the accounts once the payment has been made, immediately following the issue of a payment order. Nearly all developing countries use cash accounting systems which means that transactions are only recorded once the payment has been made. Because cash-based systems effectively hide decisions and transactions with credit and debit implications, they obviously allow for less fiscal transparency.

Figure 2.
The Budget Implementation Process



Accounts are closed for the year

The one-year period for which a budget is voted is called the financial year. Although a twelve-month period, it does not necessarily coincide with the calendar year and varies by country. At the end of this period, accounting officers or their delegated staff (often the Chief Financial Officer) record all the outstanding revenue and expenditure transactions that were effected in the relevant financial year. Once all these transactions are recorded, the accounting officer prepares final accounts of the entity's financial operations for the relevant year. These final accounts are included in the year-end report that is forwarded to the SAI for auditing.

2.4 Audit Phase

Auditing is a process undertaken to enable an auditor to express an opinion as to whether or not the financial statements of an MDA fairly present the financial position of the entity at a specific date in accordance with a specified financial reporting framework and/or statutory requirements. Similar objectives apply to audits of non-financial information conducted in accordance with a non-financial reporting framework.

There are three main types of audit that are undertaken by supreme audit institutions:

- First, a compliance audit tries to establish whether the relevant entity has complied with the relevant statutory obligations with regards to financial management and accounting. Compliance auditing does not determine whether the financial transactions of the entity have been conducted appropriately but merely whether the relevant rules have been complied with.
- Second, a financial audit tries to establish whether or not the financial statements of the relevant entity are accurate, complete, and fairly presented. Such audits can be conducted in two ways. First where internal systems and controls are strong enough, the auditors compare sets of financial information with non-financial information to test for consistency and see whether any apparent inconsistencies can be explained. Where internal systems and controls are not strong enough to produce reliable financial information, auditors compare financial information to hard evidence for such information such as invoices or bank statements.
- The third main type of audit is a performance audit (also known as Value for Money or VFM auditing). Performance audits measure the economy, efficiency, and effectiveness in the use of available resources. In short, these audits try to measure the extent to which the relevant entity is achieving its stated mission or objectives.

In Francophone countries, the supreme audit institution is part of the justice system and is known as the “*Cour de Comptes*.” This body’s reports, however, are still referred to the legislature and processed as described below.

The role of the legislature in the audit process can be influenced by the audit system that is followed by the country. In countries following the “*Cour des Comptes*” system—or Court of Accounts (typically in Francophone countries)—audit issues are dealt with by judges of the Court of Accounts. Under this system, the legislature has a limited role in the audit process and the President of the Court of Accounts sends audit reports to the legislature only at his/her discretion. However, even in this system, the Court of Accounts submits a report to the legislature on the extent to which the implementation of the budget corresponds to budgeted appropriations—and the legislature has the power to request the Court to conduct an audit of a specific government entity. Importantly, the Court of Accounts has the power to impose sanctions on the executive for failure to comply with the financial management laws of the country. The legislature can support sanctions imposed by the Court of Accounts by adding political weight to the sanctions.

In countries following the board (or collegiate) system, the national audit institution submits its audit reports to the executive (specifically, to the national Cabinet or Council of Ministers). The executive in turn sends its annual report (along with audit findings and its comments on specific audit findings) to the legislature. Legislative deliberations on the executive’s annual report are attended by the staff of the national audit institution, who explain the audit opinions and decisions contained in the report.

In countries following the Westminster system of government, the national audit institution actively supports legislative oversight of budget implementation. In this system, the legislature’s oversight function is largely directed by the contents and findings of audit reports. The legislatures in these countries often establish committees known as Public Accounts Committees (or PAC), which are responsible for overseeing the audit reports on behalf of the legislature. The PAC organizes hearings on audit findings at which officials from the relevant government agencies testify on the contents of audit reports.

In some countries, PACs also have a formal mandate to initiate and conduct their own investigations so that their oversight is not limited to the issues contained in audit reports. These PACs are empowered to summon officials to appear before them—though relatively few actually use their power to take up issues that are not contained in audit reports. Upon completion of their hearings, PACs compile reports offering recommendations for specific actions to be performed by the relevant agencies and submit them to the entire legislature for debate and action. Importantly, the audit institutions generally do not have the power to sanction the executive for non-adherence to public finance laws and instead rely on the legislature to impose such sanctions on the government.

The legislature’s role in the budget process should not end with the submission of its recommendations for actions needed to respond to audit findings. In some coun-

tries, the executive is required to formally respond to the recommendations made by the legislature—normally within a certain period, such as within two to six months of receiving the report from the legislature. The legislature, in turn, can review the executive’s response to its recommendations and decide to take further action if it is not satisfied with the response. Unfortunately, in practice, governments often choose to ignore legislative audit recommendations.

Sometimes, however, audit reports produced by the national audit institution may include information on its previous audit findings and on the government’s response to those findings. This type of reporting allows the legislature to continue to review the executive’s response to its recommendations and make additional recommendations to the executive on matters previously raised.

For example, in India, the executive is required to report to the PAC on the actions taken or proposed to be taken by it on the recommendations contained in the PAC’s report within six months of the presentation of this report by the PAC. The reported information is used by the PAC to prepare an Action Taken Report, which is presented to the entire legislature. The executive is also required to report to the PAC regarding the action taken or proposed to be taken by it in response to the recommendations contained in the Action Taken Report. The executive then furnishes final replies regarding actions made in response to items contained in the original PAC report for which final responses had not previously been received. This information is presented to the legislature as a statement without any further comments by the PAC. This iterative system not only ensures the executive remains accountable to the legislature but also enables the legislature and the public to review the executive’s responses to the PAC’s recommendations.

3. Which Information Is Needed to Monitor These Actions and Decisions?

In this section we look at the documents that need to be produced in each phase of the budget process in order to make government’s fiscal operations transparent.

3.1 Budget Formulation Phase

Pre-budget Report

A pre-budget report serves the purpose of concluding and formalizing the broad prioritization phase of the budget process and consolidating the main budgeting ceilings.

According to the OECD’s *Best Practice Guide to Budget Transparency* (2000), a pre-budget report should state explicitly the government’s long-term economic and fiscal

policy objectives and the government's economic and fiscal policy intentions for the forthcoming budget and, at least, the following two fiscal years. It should highlight the total level of revenue, expenditure, deficit or surplus, and debt.

As the only document released on the budget during the formulation phases, it has the ability to encourage debate on the budget aggregates and how they interact with the economy and to create appropriate expectations for the budget itself. The OECD also recommends that this document should be released no later than one month prior to the introduction of the budget proposal.

Executive's Budget Proposal

The executive's Budget Proposal is the detailed statement of the executive's proposed revenue and expenditure plans that is tabled in the legislature. As such it should contain extensive detail on all categories of expenditure and all source of tax revenue. Some of the more detailed elements that OECD's transparency code demands are:

- A detailed commentary on each revenue and expenditure program.
- Non-financial performance data, including performance targets, should be presented for expenditure programs where practicable.
- The budget should include a medium-term perspective illustrating how revenue and expenditure will develop during, at least, the two years beyond the next fiscal year. Similarly, the current budget proposal should be reconciled with forecasts contained in earlier fiscal reports for the same period; all significant deviations should be explained.
- Comparative information on actual revenue and expenditure during the past year and an updated forecast for the current year should be provided for each program. Similar comparative information should be shown for any non-financial performance data.
- Expenditures should be presented in gross terms. Ear-marked revenue and user charges should be clearly accounted for separately. This should be done regardless of whether particular incentive and control systems provide for the retention of some or all of the receipts by the collecting agency.
- Expenditures should be classified by administrative unit (e.g., ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
- A comprehensive discussion of the government's financial assets and liabilities, non-financial assets, employee pension obligations, and contingent liabilities.

3.2 Legislative Phase

Enacted Budget²

After debating the executive's budget, the legislature typically votes some form of the budget or appropriation into law. The term "enacted budget" refers to the document that has been passed into law by the legislature. Countries include very different levels of detail into this law. Some would legally specify allocations to individual spending agencies and even programs within them, while others would only specify overall expenditure levels. This level of detail is important because the enacted budget is the only document that has a legal status. The level of detail in it therefore delimits the extent to which government can change the budget during the year without returning to the legislature for authorization to change spending plans.

The enacted budget is important for monitoring purposes because it states what government is supposed to spend in the coming financial year. As such it provides a standard against which to measure expenditure.

Naturally, the amount of detail that can be included in the enacted budget (and the budget proposal even) would depend on the information that is generated by the budget system of the relevant country. So, for example, countries that do not have a program budget might find it difficult to produce budget information for budgeted programs.

Report of the Finance Committee

Apart from the Finance Act, the only other document that is produced in this phase of the budget process is the Finance Committee report on its review of the budget. While these reports have no standard format, this is generally where proposed amendments are recorded and passed on to the plenary.

3.3 Budget Implementation

Within government, the monitoring of implementation generally occurs over specified periods ranging from monthly to quarterly to annually, and to the related reports produced.

In the budget implementation phase, governments traditionally monitor expenditure, revenue, and debt levels much more thoroughly than they monitor delivery. Many governments produce monthly, quarterly, biannual, and annual reports that provide this information.

Such information is used for political as well as administrative accountability. At an administrative level, departmental accounting officers would use such information to hold their line managers to account. Politically, ministers and cabinets use this informa-

tion to hold accounting officers and each other to account. In some cases the legislature also uses such information to hold the executive to account.

Given the nature of these reports, they are more useful for monitoring inputs and compliance with the budget rather than outputs, outcomes, and delivery. All that many of these reports succeed in doing is to show whether the expenditure, revenue, and debt provisions of the budget are being adhered to. They do not show whether the budget is delivering the services that it was meant to. Monitoring of service delivery only becomes possible where government monitors and reports on service delivery. Very few countries however succeed in doing so.

In-year Reports

In-year reports report on government expenditure and revenue collection during the financial year. They typically report on a quarterly or monthly basis. For this reason they are sometimes also referred to as *monthly reports* or *quarterly reports*. In-year reports can be issued in the form of one consolidated report for the entire government, or multiple reports can be issued by different agencies. For example, the Central Bank can issue them, in addition to the Ministry of Finance. In some cases, revenue collection agencies issue their own separate reports.

In some countries, the Central Bank, rather than the executive, issues these reports based on the status of the government's bank accounts. In these cases, the Central Bank's reports can be used as in-year reports, as long as they report what has actually been spent, rather than on the monthly sums that have been transferred to administrative units.

As was the case with enacted budgets, countries do not report at the same level of aggregation; some would report in the finest detail on individual program expenditure and revenue from individual taxes while others would only reflect total revenue and expenditure for the government as a whole.

In some countries, the reports are issued individually by each administrative unit, while in other countries the information is consolidated into one report, which is typically issued by the Treasury. Either individual reports or one consolidated report is acceptable for responding to these questions.

Year-end Reports

Year-end reports consolidate information on the actual expenditures of administrative units, revenue collections, and debt. In some countries this would be a single document for all of government, while in other countries, individual administrative units issue their own year-end reports. Similarly, year-end reports may be stand-alone documents or may be included in larger documents, such as the budget. The form of the report is less important than its content.

The OECD recommends that a year-end report be released within six months of the end of the fiscal year. The reports should cover all of the major items that were presented in the budget, explaining differences between the original estimates (as amended by the legislature during the year) and actual outcomes for expenditure, revenue, debt, and macroeconomic assumptions. They should also include non-financial performance information.

In-year and year-end reports are important for monitoring purposes because they indicate to what extent the government adhered to the content of the enacted budget.

Supplementary Budget

Supplemental budgets are effectively amendments to the enacted budget. Although supplemental budgets are not uncommon in most countries, the habitual use of large supplemental budgets can be an indication of poor budgeting practices. Routine supplemental requests undermine planning within ministries and agencies. They also interfere with open and public debate on allocation of resources among budget categories, since in theory this should occur as the legislature reviews the executive's budget proposal each year.

Supplementary budgets are important for monitoring purposes because they indicate which deviations from the enacted budget have been agreed to by the legislature.

3.4 Auditing Phase

“Audit reports” refer to the report or reports issued by the Supreme Audit Institution attesting to the completeness and reliability of the government's year-end final accounts. These audits are sometimes known as “certification of the government accounts.”

According to OECD best practices, the SAI should complete these audits within six months of the end of the budget year for administrative units (i.e., ministries, departments, or agencies).

Audit reports are important for monitoring for two reasons. First, audit reports typically indicate whether financial management procedures were adhered to in the implementation of the budget. Second, audit reports indicate whether deviations from the enacted budget were justified or not.

The other important document that is produced in this phase of the budget process is the legislature's Public Accounts Committee (PAC) report that is produced after the PAC has considered the audit reports that were produced on the government's accounts. These reports are referred to the plenary for further discussion and action.

4. Quality of Fiscal Information

Fiscal information has very little inherent value. A whole series of qualities described below need to be reflected in this information before it becomes useful for accountability purposes.

4.1 Accuracy/Validity of Fiscal Information

One of the most important requirements of fiscal information is that it corresponds to the reality of the government's finances. At a first level this means what government actually spends and collects in revenue must correspond to some degree with what its budget proposals show. So when, for example, less than half of what was budgeted for primary healthcare is spent on primary healthcare, then the printed estimates for primary healthcare cease to be a useful accountability tool.

At a second level, actual revenue and expenditure figures also cease to be useful when they do not reflect what government has actually spent. In many cases governments' actual expenditure is, for example, given the lie by outstanding payments or transactions that have been effected but not captured by the accounting system.

Obviously, the vagaries of budget implementation makes some level of divergence from budgeted figures inevitable. For this reason many governments make provision for such divergence through virement regulations and contingency reserves. Virement regulations govern the amounts of money that may be shifted between items in the budget. In many countries such shifts would be limited to a certain percentage of the original amounts approved by the legislature. In other cases these regulations would limit the kinds of expenditure that may be shifted, for example, forbidding shifts from infrastructure to personnel expenditure provisions.

Many governments also plan for the unforeseen by creating contingency reserves. These reserves are amounts of money set aside for unforeseen and unavoidable expenditures such as floods or sudden changes in the price of fuel.

4.2 Timeliness

From a transparency and accountability perspective, the value of fiscal information is bound to specific decisions and their consequences. Information on how much money is to be spent on healthcare, for example, has value while that decision is being made, implemented, and audited, but after each of these steps the relevant information ceases to be useful. So information that government releases too late ceases to be useful, regardless of how accurate it may be.

An example of information that becomes useless because it is released late would be when the executive's budget proposal is only released to the public after it has been approved by the legislature. This information could still be useful to monitor the implementation of the budget, but it has ceased to be useful for the debate about what government should spend because that decision has been made.

Another example would be when governments only release audit report a number of years after the financial year that it refers to. Very often the officials and politicians that were responsible for the decisions reflected in such reports are no longer in the same posts, so such reports cease to be useful in holding the executive to account.

4.3 Comprehensiveness

Very often budget information that is both accurate and timely is still limited if it is not comprehensive. Governments often leave specific transactions out of their budgets or even whole institutions such as parastatals or designated development funds.

Governments often go to great lengths to hide their fiscal risks, levels of indebtedness, or contingent liabilities. Such hiding often takes place in developing countries that are dependent on positive perceptions of their fiscal health to access concessional debt.

4.4 Levels of Disaggregation of Information

Apart from the actual quality of fiscal information, the ways in which it is presented also influences how useful fiscal information is. The most important presentation issue is the level to which it is disaggregated. As a general rule fiscal information should be sufficiently disaggregated to allow scrutiny of all its fiscal operations and decisions. For example, an education department would make decisions on how much money to spend on school books in its primary education program. A budget that only gives the total budget for education would not allow us to examine that decision. Nor would one that only gives us a total for primary school education.

4.5 Comparability

The appropriateness of proposed revenue and expenditure projections or actual expenditure can generally only be examined by comparing it to something else. These projections are often compared to last years allocations. Or comparisons are made between countries. Or budgeted expenditure is compared with actual expenditure. But these comparisons are only possible if these sets of information are produced using the same classifications and categorizations.

For this reason governments should not incessantly tinker with their budget classification system because it undermines the comparability of its data. Over the last 20 years or so, the International Monetary Fund has had some success in introducing a standard classification system called Government Financial Statistics (GFS).

4.6 Simplicity

A less specific presentation rule that fiscal information should adhere to is simplicity. In many countries governments have had some success in presenting tables and pictures that make complex statistics more generally comprehensible.

5. How Fiscally Transparent Are Governments?

This section is a discussion of the results of the IBP's 59-country Open Budget Initiative (OBI). Table 1 shows that, with the exception of pre-budget statements and mid-year reports, the majority of countries provide some version of the reports that make up fiscal transparency.

Table 1.
Open Budget Index 2006

What Countries Open Their Budget Books to Citizens?	
Provides Extensive Information to Citizens	France, New Zealand, Slovenia, South Africa, United Kingdom, United States
Provides Significant Information to Citizens	Botswana, Brazil, Czech Republic, Norway, Peru, Poland, Romania, South Korea, Sweden
Provides Some Information to Citizens	Bulgaria, Colombia, Costa Rica, Croatia, Ghana, Guatemala, India, Indonesia, Jordan, Kazakhstan, Kenya, Malawi, Mexico, Namibia, Pakistan, Papua New Guinea, Philippines, Russia, Sri Lanka, Tanzania, Turkey
Provides Minimal Information to Citizens	Albania, Algeria, Argentina, Azerbaijan, Bangladesh, Cameroon, Ecuador, El Salvador, Georgia, Honduras, Nepal, Uganda, Zambia
Provides Scant or No Information to Citizens	Angola, Bolivia, Burkina Faso, Chad, Egypt, Mongolia, Morocco, Nicaragua, Nigeria, Vietnam

Note: A country's placement in a performance category was determined by averaging the responses to the 91 questions on the Open Budget Questionnaire related to information contained in the seven key budget documents that all countries should make available public. The countries that scored between 81–100 percent were placed in the performance category Provides Extensive Information, those with scores 61–80 percent in Provides Significant Information, those with scores 41–60 percent in Provides Some Information, those with scores 21–40 percent in Provides Scant or No Information.

The more detailed examination that follows, however, points out that while many countries produce some information, this information is often not of particularly good quality.

A second important point that can be deduced from this summary table is that in a significant number of cases government produces more information than it releases to the public. It would therefore be possible for governments to become more fiscally transparent without having to invest in producing more information.

5.1 Budget Formulation

Table 2 below shows that of the 59 countries surveyed only nine provide no executive budget proposal at all. However a total of 39 provide limited or no information on the executive’s budget proposal. This imposes a substantial limit on the ability of the public to engage with the executive’s spending and taxation priorities.

This needs to be seen against the context of 36 countries either not releasing or not producing a pre-budget statement. So in more than half the countries surveyed, there is limited or no information available on the executive’s spending plans.

Table 2.
Executive’s Budget Proposal

Quality of Publicly Available Information by Country	
Provides Extensive Information to Citizens	France, New Zealand, South Africa, United Kingdom, United States
Provides Significant Information to Citizens	Botswana, Brazil, Colombia, Czech Republic, Ghana, Malawi, Norway, Papua New Guinea, Peru, Poland, Romania, Slovenia, South Korea
Provides Some Information to Citizens	Algeria, Argentina, Azerbaijan, Bangladesh, Bulgaria, Cameroon, Costa Rica, Guatemala, Honduras, India, Indonesia, Jordan, Kazakhstan, Kenya, Mexico, Nepal, Pakistan, Philippines, Sri Lanka, Tanzania, Turkey, Uganda
Provides Minimal Information to Citizens	Bolivia, Croatia, Ecuador, El Salvador, Georgia, Nigeria, Russia, Zambia
Provides Scant or No Information to Citizens	Albania, Angola, Burkina Faso, Chad, Egypt, Mongolia, Morocco, Nicaragua, Vietnam

Note: A country’s placement in a performance category was determined by averaging the responses to the 91 questions on the Open Budget Questionnaire related to information contained in the seven key budget documents that all countries should make available public. The countries that scored between 81–100 percent were placed in the performance category Provides Extensive Information, those with scores 61–80 percent in Provides Significant Information, those with scores 41–60 percent in Provides Some Information, those with scores 21–40 percent in Provides Scant or No Information.

Of course, fiscal transparency is not just about what government intends to spend, but also about what it intends to buy or deliver with the money that is allocated. Information about what will be delivered and in which quantities make it possible for us to monitor the extent to which government spending is contributing to policy goals. Two-thirds of the countries surveyed provide no performance indicators in the executive budget proposal. This gap in budget documentation makes it close to impossible to measure government’s effectiveness and efficiency in the use of public money. This turns most of the public budgeting and accountability process into a compliance exercise where the evaluation of government fiscal performance is limited to discussions of whether regulations were complied to rather than dealing with whether stated policy goals were reached.

Of the countries that do publish such performance information, only one does so reasonably well (United Kingdom). In most other cases performance measures are either not measurable or bear no relation to the stated policy goals of the government.

5.2 Budget Implementation

The picture looks slightly better when it comes to information on budget implementation. Table 3 below shows that only 12 of the 59 countries surveyed provided no information on the implementation of the budget during the financial year.

Table 3.
In-year Reports on Execution

Quantity of Publicly Available Information by Country	
Top Performer: Provides Much Information to Citizens	Brazil, Bulgaria, France, Mexico, Mongolia, New Zealand, Peru, Poland, Romania, Slovenia, South Africa, Sri Lanka, Sweden, Turkey, United States
Provides Partial Information to Citizens	Albania, Argentina, Bangladesh, Botswana, Burkina Faso, Colombia, Croatia, Czech Republic, Ecuador, Egypt, El Salvador, Georgia, Guatemala, Honduras, India, Jordan, Kazakhstan, Kenya, Malawi, Morocco, Namibia, Nepal, Nicaragua, Norway, Pakistan, Papua New Guinea, Philippines, Russia, South Korea, Tanzania, United Kingdom, Zambia
No In-year Reports Made Available to the Public	Algeria, Angola, Azerbaijan, Bolivia, Cameroon, Chad, Costa Rica, Ghana, Indonesia, Nigeria, Uganda, Vietnam

Note: The country’s percentage score for In-Year Reports on Execution was obtained by averaging the responses to Questions 84–92 on the Open Budget Questionnaire. The countries that scored between 90–100 percent were placed in the performance category Top Performer, those with scores 89 percent or below, but more than zero percent were placed in performance category Provides Partial Information, those with scores of zero percent were placed in the category No In-year Reports Made Available to the Public.

However, another 32 only provide partial information on execution. This normally means that the figures that are released are very highly aggregated, with the worse case scenario being where quarterly or monthly reports only contain information about overall levels of government revenue and expenditure. In these cases the limitation lies with the fact that such figures do not allow one to monitor progress with the collection of any specific tax or realization of any specific expenditure.

In-year reports allow one to monitor the implementation of the budget of the year currently in progress. Year-end reports are generally more comprehensive and allow an overview of how the budget as a whole was implemented. It also forms the basis for the work of the Supreme Audit Institution and the Public Account Committee in parliament.

Table 4 below shows similar picture to the one painted above. Only nine countries do not release any year-end report at all, but another 32 countries' reports only contain limited information.

Table 4.
Year-end Report

Quantity of Publicly Available Information by Country	
Top Performer: Provides Much Information to Citizens	Brazil, France, New Zealand, Poland, Slovenia, South Africa, South Korea, Sweden, United Kingdom
Provides Partial Information to Citizens	Albania, Algeria, Angola, Argentina, Bolivia, Botswana, Bulgaria, Burkina Faso, Chad, Colombia, Costa Rica, Croatia, Czech Republic, Ecuador, Egypt, El Salvador, Georgia, Guatemala, Honduras, India, Indonesia, Jordan, Kazakhstan, Kenya, Mexico, Mongolia, Morocco, Namibia, Nepal, Nicaragua, Norway, Pakistan, Papua New Guinea, Peru, Philippines, Romania, Russia, Sri Lanka, United States, Vietnam, Zambia
No Year-end Report Made Available to the Public	Azerbaijan, Bangladesh, Cameroon, Ghana, Malawi, Nigeria, Tanzania, Turkey, Uganda

Note: The country's percentage score for Year-end Report was obtained by averaging the responses to Questions 102–111 on the Open Budget Questionnaire. The countries that scored 80–100 percent were placed in the performance category Top Performer, those with scores 79 percent or below, but more than zero percent were placed in performance category Provides Partial Information, those with scores of zero percent were placed in the category No Year-end Report Made Available to the Public.

Given the limited amount of performance information provided in the executive's budget proposal, it is unsurprising that most countries also do not include much performance information in their year-end reports. Table 5 tells the story.

Table 5.
Level of Information in Year-end Budget Documents Comparing Original
Performance Indicators and Actual Outcomes in 59 Countries

An extensive explanation of the differences is presented, including both a narrative discussion and quantitative estimates.	4
An explanation is presented, highlighting key differences, but some details are excluded.	7
Some explanation is presented, but it lacks important details.	4
An explanation is not presented, or such a report is not released.	44

Source: IBP's Open Budget Index 2006.

5.3 Audit Phase

Disappointingly, 18 of the countries surveyed do not release the audited reports of government accounts to the public. In thirteen of these cases audit reports are not produced at all, while five produce them, but do not release them to the public.

Another 25 release audit reports publicly, but limit the information contained in them. This severely limits the ability of the public to engage with the review of the integrity of government accounts. In many cases it also limits the ability of the legislature to perform its oversight function.

Table 6.
Auditor's Report

Quantity of Publicly Available Information by Country	
Top Performer: Provides Much Information to Citizens	Colombia, Croatia, France, India, Mongolia, New Zealand, Norway, Philippines, Poland, Russia, Slovenia, South Africa, South Korea, Sweden, United Kingdom, United States
Provides Partial Information to Citizens	Albania, Bolivia, Botswana, Brazil, Bulgaria, Costa Rica, Czech Republic, Georgia, Guatemala, Honduras, Indonesia, Jordan, Kazakhstan, Kenya, Mexico, Namibia, Nepal, Pakistan, Peru, Romania, Sri Lanka, Tanzania, Turkey, Uganda, Zambia
No Auditor's Report Made Available to the Public	Algeria, Angola, Argentina, Azerbaijan, Bangladesh, Burkina Faso, Cameroon, Chad, Ecuador, Egypt, El Salvador, Ghana, Malawi, Morocco, Nicaragua, Nigeria, Papua New Guinea, Vietnam

Note: The country's percentage score for Auditor's Report was obtained by averaging the responses to Questions 112–114, and 116 on the Open Budget Questionnaire. The countries that scored 80–100 percent were placed in the performance category Top Performer, those with scores 79 percent or below, but more than zero percent were placed in performance category Provides Partial Information, those with scores of zero percent were placed in the category No Auditor's Report Made Available to the Public.

5.4 Engagement with Fiscal Information

As was indicated in the text above, substantial fiscal transparency does not only demand that government produces and distributes the relevant documents, but also that the appropriate institutions and sectors of society engage with them for accountability purposes. Below, we look at the extent to which one such institution, the legislature, engages with some of the documents produced by government.

Table 7 below shows that in 24 of the 59 countries surveyed in the OBI, no public hearings are held on the government’s proposed macroeconomic framework. In another, 16 such hearings are held, but the public does not have the opportunity to engage with this framework itself. So in more than two-thirds of cases the legislature does not facilitate public scrutiny of one of the key aspects of the budget formulation phase of the budget process.

Table 7.
Are Public Hearings on the Budget’s Macroeconomic Framework Held?

Are Public Hearings on the Budget’s Macroeconomic Framework Held?	
Testimony is heard from the executive and a wide range of constituencies	Norway, Philippines, Poland, Slovenia, South Africa, South Korea, Sweden, Uganda
Testimony is heard from the executive and some constituencies	Brazil, Bulgaria, Colombia, Georgia, Guatemala, Kazakhstan, Kenya, Mexico, Russia, United Kingdom, United States
Testimony is heard from the executive branch, but no testimony is heard from the public	Albania, Argentina, Chad, Costa Rica, Croatia, Czech Republic, El Salvador, France, Ghana, Malawi, New Zealand, Nigeria, Pakistan, Peru, Romania, Turkey
Public hearings are not held on the macroeconomic and fiscal framework	Algeria, Angola, Azerbaijan, Bangladesh, Bolivia, Botswana, Burkina Faso, Cameroon, Ecuador, Egypt, Honduras, India, Indonesia, Jordan, Mongolia, Morocco, Namibia, Nepal, Nicaragua, Papua New Guinea, Sri Lanka, Tanzania, Vietnam, Zambia

Note: Response by country to Question 76 of the Open Budget Questionnaire.

Table 8 shows that in legislatures’ consideration of the executive budget proposal, almost half of them do not hold public hearings on the budgets of MDAs. Only eight of them have extensive hearings covering all or most of the MDAs included in the budget. This gives some indication of a lack of demand for transparency on behalf of the legislature that is independent of the willingness of the executive to supply it.

Table 8.
Do Legislative Committees Hold Public Hearings
on the Individual Budgets of MDAs?

Extensive public hearings are held.	8
Hearings are held, but only cover key administrative units.	15
A limited number of hearings are held.	11
Public hearings are not held.	25

Source: IBP's Open Budget Index 2006.

The picture looks considerably better when one looks at legislatures' role in the audit phase of the budget process. Half of them scrutinize all audit reports while only 10 do not scrutinize any reports.

Table 9.
Level of Scrutiny of Audit Reports by Legislative Committee in 59 Countries

All audit reports are scrutinized.	29
Most audit reports are scrutinized.	7
Some audit reports are scrutinized.	13
Audit reports are not scrutinized.	10

Source: IBP's Open Budget Index 2006.

The picture gets a little darker again when one looks at whether legislatures report on the actions that they take a result of their scrutiny of Audit reports. In almost three-quarters of cases no report is released or it lacks significant details. So while the legislature may be holding government to account for audit findings, it does not allow the public to enhance this process by releasing its work publicly.

Table 10.
Level of Reporting on Action Taken in Response to Audit Findings in 59 Countries

A comprehensive report is released regularly that tracks actions taken by the executive to address audit recommendations.	3
A report is released covering key audit recommendations, but some details are excluded.	10
A report is released, but it lacks important details.	7
A report is not produced or it is prepared for internal purposes only.	39

Source: IBP's Open Budget Index 2006.

6. Conclusions

In this chapter we started off by looking at some of the historical and definitional issues around fiscal transparency. Next, we looked at the decisions and actions that make up the government budget process as well as the information and documents that would render it transparent. Lastly, we looked at how some governments perform with regards to fiscal transparency.

The overview of the results of the Open Budget Index 2006 show that on currently available information there are significant parts of the budget process where the executive cannot be held accountable because it does not release public information that shows us what it is doing.

In order to improve this situation, we need to learn a lot more about what encourages and drives effective fiscal transparency. In many developing countries a “*pro forma*” transparency has been enforced by the conditionalities of international financial institutions. But in most of these cases the accountability institutions that would enliven fiscal transparency and accountability relationships are virtually dormant. This is the first point where transparency could be shored up; namely by better understanding the contribution of accountability institutions and then building them.

The second, fairly easy, way of improving on transparency would be for governments to release more of the information that they already produce. In many cases the reasons are more linked to defunct organizational culture than any substantive issue.

The third and more challenging improvement would be to strengthen the executives’ ability to produce reliable fiscal information.

In the long run executives are under pressure from markets, donors, and accountability institutions to render its fiscal operations more transparent. So it is easy to predict improved production and distribution of fiscal information. The bigger challenge is to ensure that legislatures, civil society and the media are capable of using this information to ensure greater accountability.

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Notes

- ¹ This section draws on the author's contributions to Ramkumar 2007 Mimeo.
- ² These paragraphs and subsequent descriptions of budget documents draw heavily from the "Guide to the Open Budget Questionnaire: An Explanation of the Questions and the Response Options," International Budget Project, October 2005, Mimeo.

Tax Policies and Tax Administration for Minimizing Fraud

Stan Beesley

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Abstract

Corruption in a tax administration has serious, adverse consequences for the revenue collections of a government. As in other public institutions, corruption takes many forms in a tax administration. If a tax administration lacks transparency in its dealings, there will be a perception of corruption, whether real or not. To achieve its maximum effectiveness, a tax administration depends on the voluntary compliance of the taxpayers it serves. A corrupt tax administration will not be able to gain the trust of the public, and therefore will not be effective in collecting the revenue necessary for its government to provide services to its constituency. There are many strategies for addressing corruption. Generally, focusing on one single strategy will not be adequate to deal with issues of corruption.

This chapter examines:

1. the various kinds of corruption that can occur with respect to taxes;
2. the impact of corruption (inefficiency, loss of trust, etc.), whether perceived or real;
and
3. some of the ways in which corruption in a tax administration can be minimized.

1. Tax Administration and Corruption

The core activity of every revenue body is the effective administration and implementation of the tax laws. This means collecting the tax legally due under domestic legislation while fully respecting the rights of taxpayers. Revenue bodies are under constant pressure to close the gap between the tax legally due and the tax actually collected. To do this, we strive to provide a tax administration system that is efficient, effective and provides high standards of service to taxpayers and other stakeholders and, at the same time, collect the revenues required by law to fund necessary public services (OECD 2006).

The tax system has become a means through which governments influence economic and social policies. From a theoretical view, a tax system should be neutral in terms of influencing investment and operational decisions of enterprises operating in the country or considering investment in a country. The OECD has addressed this issue in part through its Harmful Tax Practices Project.¹ The administration of a tax system is clearly a factor in terms of providing certainty and transparency for domestic and international investors. For discussion of the impact of uncertainty on investment, particularly related to the Maquildora industry in Mexico, see McLees 2004.

In a legal opinion from a case involving tax litigation, American Supreme Court Justice Oliver Wendall Holmes wrote, “Taxes are the price we pay for a civilized society.” There are few greater responsibilities of a government than to provide the environment and opportunities for its population to prosper. From the earliest days of recorded history, governments have collected taxes—initially, to pay for wars and defense, and in more recent times to pay for social programs, infrastructure, education, healthcare, police protection, fire protection, and other programs that the public demands from its government in ensuring a “civilized society.”

The tax administration in a society touches virtually every member of that society, and, other than for certain public services, may be the only face of government that a citizen may see. Society has a right to expect that a tax administration will conduct its affairs with transparency, provide certainty in treatment, serve taxpayers with a high standard, and collect the revenue effectively and efficiently while respecting the rights of each taxpayer. When that does not happen, it weakens the fabric of society and generates doubts about the legitimacy of the government. “No problem does more to alienate citizens from their political leaders and institutions, and to undermine political stability and economic development, than endemic corruption among the government, political party leaders, judges, and bureaucrats” (USAID 2005).

Just as a tax system of some kind has existed since early days, so have opportunities for corruption in administering the tax system existed since the early days of recorded history. This chapter examines:

1. the various kinds of corruption that can occur with respect to taxes;
2. the impact of corruption (inefficiency, loss of trust, etc.), whether perceived or real; and
3. some of the ways in which corruption in a tax administration can be minimized.

Obviously, in this short concept chapter it is not possible to cover the subject in depth. This chapter is not intended to be an academic research paper, but is written more from the perspective of a tax administrator, drawing on experiences gained over a career as a tax administrator, and is a review of some of the more pertinent writings on the subject of corruption and tax administration. For that reason, it is important to study the recommended reading and other sources in order to draw conclusions relative to best practices that may address corruption issues in a tax administration. This paper will not address issues related to tax fraud, although that often exists in connection with corruption. This paper is also directed at corruption in a national tax administration, recognizing that corruption in local tax administrations takes similar forms and approaches to those applied in national tax administrations, but that there are also differences created by the increased opportunities for corruption at the local level. Some common terms associated with tax administration are defined in Annex 1.

2. The Many Faces of Corruption in Tax Administration

A definition of corruption, widely accepted by many international organizations (World Bank, USAID, Transparency International, and others) is *the abuse of public power*. (USAID substitutes “entrusted authority” for private benefit)

Corruption in revenue administration is caused by the aggregate effects of numerous decisions by taxpayers, revenue officers, and political decision makers. The literature distinguishes between two main categories of factors contributing to corruption:

- Elements that affect the *motivation* (or incentives) to engage in corruption, and
- Elements that create *windows of opportunity* for corrupt activities.

The motivation for corrupt acts may differ both within groups of stakeholders, for instance between different taxpayers depending on the types of taxes, excises, and duties—and between groups of stakeholders. The various stakeholders’ perspectives must therefore be taken into consideration for identifying key factors impacting on their motivations and opportunities to engage in corruption (O-H Fjeldstad 2005).

The primary stakeholders relative to corruption in a tax administration are tax officials, taxpayers, and politicians. This chapter will look at some of the causes of corruption more closely in sections dealing with the impact of corruption and means of addressing corruption.

2.1 Political Corruption

Many writers divide corruption into two categories—administrative (bureaucratic) corruption and grand (political) corruption. Grand corruption usually involves high-level officials of a tax administration, or tax policy organization, who may grant tax exemptions to companies in exchange for money or other favors. In many countries, the tax policy function and tax administration functions are in separate government organizations (tax policy usually in the Ministry of Finance and tax administration in a separate organization under the Ministry of Finance), so that the tax administration is isolated from the external pressures exerted on those who make policy. However, some countries still have policy and administration in the same organization. In these countries, the tax administration faces the additional risk of corruption associated with the passage of laws that may impact one group of taxpayers more than another, or may be more favorable to one group of taxpayers than another.

Grand corruption is not limited to situations involving just one taxpayer. Industry lobbyists may engage in grand corruption with a senior tax administration official in attempting to influence a tax ruling affecting their industry by providing vacation homes, free travel, payment for children's education, home remodeling, etc., in exchange for a favorable ruling. Many years ago, the revenue department in the Tanzania Ministry of Finance was nicknamed the Tax Exemption Department for its corrupt practices of granting tax-exempt status to businesses in exchange for favors (O-H Fjeldstad 2002). Another form of grand corruption is providing the political party in power with tax return information on political enemies in exchange for enhancing a career, monetary gain, personal satisfaction, etc. In the 1970s, in the United States, for example, then President, Richard Nixon, sought to use tax return information to discredit his political enemies and requested such information from the tax administration. Such abuses are not limited to developing countries.

In countries with significant corruption, attempts to pass tax legislation may meet resistance of the tax officials who may see the new legislation as interfering with their existing corrupt practices. As a result, they will resist the legislation and may even give misleading testimony regarding the proposed legislation. This is particularly true with respect to legislation designed to reform the tax administration.

Nepotism, particularly in developing countries, is a form of corruption that does not necessarily result in receipt of any material benefit in exchange for hiring a relative, unless the relative is a spouse. In many countries where family ties are stronger than government rules, it is customary to hire family members and failure to do so could adversely impact family relationships. In this case, the private gain is the ability to maintain family relationships. This can be a particularly debilitating form of corruption in that it often results in unqualified workers, workers more prone to corruption as they have minimal loyalty to the tax administration, or workers who do not put forth much effort during the workday.

2.2 Administrative Corruption

Administrative corruption is considered to be a lower level of corruption than grand corruption, but both kinds are destructive in a tax administration. It should be noted that most of these forms of corruption are not unique to tax administration, but can exist in any public organization.

Administrative corruption includes such activities as receiving bribes in exchange for favors (reducing tax assessments, for example), and usually involves lower-level tax administration employees. It can include staff colluding with criminals to defraud the tax administration, providing tax return information to the media in exchange for money, unauthorized access to tax return information for personal gain, and other similar offenses. The lower-level administrative corruption is often justified in developing countries as necessary to supplement low salaries of tax administration employees. This attitude, of course, results in minimal efforts to curb the low-level corruption; however, there is no room for corruption of any kind in a tax administration that relies on the public trust for achieving a high degree of voluntary compliance.

Box 1.

Taxpayer Indicted for Bribery of an IRS Official

On February 20, 2007, Yan Borr was indicted on two counts of bribery of a public official in the U.S. District Court, Eastern District of New York.

According to court documents, on December 3, 2004, and September 19, 2006, Borr knowingly, intentionally, and corruptly gave, offered, and promised U.S. currency to a person acting on behalf of the IRS with the intent to influence an official act.

During several meetings, Borr and IRS Revenue Officers (RO) discussed his outstanding IRS tax liabilities. Borr indicated that he could not fully pay the outstanding tax liabilities, which were approximately \$15,000 and indicated that he had a couple of “bonds” that he could cash and give to the RO if the RO could take care of his situation. At another meeting, Borr met with another RO and gave the RO an envelope containing \$1,000 in exchange for the reduction of his tax liability from approximately \$22,000 to approximately \$8,500. Borr then offered and gave the RO an additional \$500 to reduce the tax liability by an additional \$2,000.

In the United Kingdom, a tax official sold confidential information to a criminal gang allowing them to steal £2.7 million (NAO).

2.3 Extortion and Theft

Tax officials may extort money from taxpayers that is not actually due. This may take the form of an additional assessment that the taxpayer ultimately agrees to under threat of severe sanctions. This often occurs in tax administrations where the sole measurement

of success is revenue; tax officials are rewarded for achieving certain revenue goals and take whatever actions are necessary to achieve those goals. When tax administrations have specific monthly revenue targets set by the government, they are tempted to engage in practices that are on the verge of extortion—demanding periodic payments that are not due, requiring taxpayers they know to be capable of making additional payments to make such payments even when tax is not due, reviewing returns when filed, and demanding that additional income be reported and additional payment made, etc. The primary purpose of these acts is not immediate monetary gain, but increased recognition in the tax administration or government for delivering needed revenue that enhances the opportunity for advancement or the avoidance of dismissal for failure to meet the target.

Theft, or misuse of revenues, is another form of corruption in a tax administration. In those tax administrations where employees come in direct contact with cash, checks, or other monetary instruments, theft is always a risk. For many years in the United States, taxpayers paid their taxes by check payable to the IRS (Internal Revenue Service). In the course of processing payments, an employee changed the name on the check to I.R. Smith and deposited the money into the account of “I.R. Smith.” As a result, the IRS has had to revise instructions to taxpayers to make their checks payable to the United States Treasury. Any checks received in an IRS office made payable to the IRS are required to be over-stamped with United States Treasury.

In countries where taxpayers rely on receiving quick refunds of withheld taxes, as in the United States, electronic filing of returns has been a major advancement and allows refunds to be paid within days of receiving the electronic file based on the showing of the bank routing number and bank account number in the file. In some cases, the tax administration makes a service available to taxpayers without reliable internet service and the taxpayer takes a paper return to the tax administration that then inputs the data for electronic filing. There have been cases in which the employee inputting the return then changes the bank routing and account number so that the refund goes into an account set up by the employee.

As in other governmental organizations, misuse of funds can take place on a much larger scale in a tax administration than the types of theft discussed above. This often takes the form of kickbacks on contracts let for services or maintenance of tax administration facilities. It could also be a kickback on a contract let for construction or remodeling of a tax administration building. Maintenance of slush funds for payment of personal entertainment or travel expenses is another common form of misuse of funds.

This is by no means intended to be an exhaustive list of all the faces of corruption in a tax administration. There are as many variations in a tax administration as can be thought of by the human mind and there are undoubtedly a number of new schemes yet to be discovered.

*Box 2.***Former IRS Employee Sentenced for Theft of Government Funds**

On January 4, 2007, former Internal Revenue Service (IRS) employee Therese Rivers was sentenced in the U.S. District Court, Eastern District of Pennsylvania, for theft of government funds. Rivers was sentenced to five years of probation, restitution in the amount of \$11,083.83, a \$100 assessment, and continued mental health treatment.

According to court documents, Rivers was charged on September 20, 2006, with one count of theft of government funds for embezzling and knowingly converting to her own use \$20,135 that a taxpayer sought to apply to his tax obligations. The taxpayer filed a tax return with the IRS, instructing it to apply prior tax overpayments in the amount of \$20,135 to his other tax obligations. Instead of processing the tax return as Rivers was required to do, she altered the tax return and made it appear that the taxpayer sought a refund of the tax overpayments and asked the IRS to deposit the refund into a bank account that Rivers had opened under a false name.

3. Does Corruption Matter to a Tax Administration?

The impact of corruption on a tax administration mirrors the impact of corruption on other governmental institutions.² However, corruption possibly impacts the tax administration more than most other governmental institutions. A basic premise in tax administration is the emphasis on voluntary compliance on the part of taxpayers. It is expected that anyone subject to taxation will correctly report their tax obligations and make timely payment of any tax that is due. Even in countries in which the tax administration determines the tax due, there is an expectation that the taxpayer will accurately report income and expenses.

If taxpayers question the integrity of the government, including tax officials, their interest in complying with the laws established by that government, including revenue laws, will be diminished.

Tanzi and Davoodi [2001] with a focus on the composition of tax revenues, assuming that different types of taxes respond differently to corruption, claim that a 1-point increase in corruption is associated with a 1.5 percentage point decline in total revenue relative to GDP, and a 2.7 percentage point decline in the ratio of taxes to GDP. Direct taxes suffer more from corruption than indirect taxes, suggesting that countries with high levels of corruption should rely more on indirect taxation—a feature that seems to be in line with current practice (J.G. Lambsdorff 2007).

3.1 Types of Taxes and Exemptions

The fact that direct taxes suffer more from corruption reflects the taxpayer's response to corruption and the resultant lack of interest, or apathy, in contributing to a government

that does not meet the expectations of the society. Direct taxes are taxes on income, while indirect taxes are generally taxes on consumption. Taxpayers have less choice in paying taxes on consumption than they have in paying taxes on income; therefore, it is generally through protesting against direct taxes that citizens make their dissatisfaction with government known. The protests can be active in terms of voicing concern and advocating reform, or it can be passive as demonstrated by non-payment of taxes, under-reporting income, failing to submit required tax returns, etc. As a result, even though the economy may be growing, tax receipts do not keep pace with economic growth. The ratio of tax revenue to GDP is often used as a measurement of the effectiveness of a tax administration, with the secondary indicator that there is a potential that there is corruption in the tax administration.

A country with a high incidence of corruption is likely to have a narrow tax base in which the larger businesses (that have a lot to lose if they do not pay some amount of taxes) are responsible for the largest share of the revenues, along with those individuals whose wage income is subject to withholding.

Fiscal corruption is likely to undermine government trustworthiness and thereby the legitimacy of the government. When the institutions are legitimate, citizens have a predisposition to consider obedience to them as reasonable and appropriate. A government's lack of legitimacy on the other hand diminishes almost by definition the perceived moral justification for obeying its laws. Of particular importance in this context is that citizens' disrespect for tax laws may initiate disrespect for other laws, leading to a vicious circle where distrust breeds distrust. In contrast, government trustworthiness and widespread public support tends to legitimize the public sector, and may so impose some social norm for paying taxes (O-H Fjelstad 2005).

Eliminating, or even reducing, corruption will assist the tax administration in its efforts to increase the tax base, ensuring that the base is broad and everyone pays their fair share. A broader base brings more citizens into involvement in society, helping to ensure the legitimacy of the government; it also helps insure against economic catastrophe in the event one or two large businesses cease operations.

3.2 Perceptions Matter

Perceptions often play a major part in people's attitudes toward the tax administration. A widely-accepted perception that corruption is pervasive in a tax administration will lead to seemingly honest people attempting to bribe tax officials. Just as corruption breeds corruption, so does one's perception become another's reality. A study done by the Centre for Tax System Integrity in Australia demonstrated this tendency in human behavior.³ While this research related to tax cheating, the same principles apply to perceptions of corruption in a tax administration. One or two incidences of corruption in a tax admin-

istration may lead the public to conclude that the tax administration is corrupt—once the perception exists, it is difficult to erase and can adversely impact compliance.

3.3 Black Economy: Loss or a “Grease”

Corruption can be a factor in the underground economy of a country. The existence of an underground economy, however, does not necessarily mean that corruption exists in the tax administration. Tax administrations worldwide are concerned about the level of the underground economy in their countries—including tax administrations in countries where corruption is not considered to be a problem (Australia, Canada, Japan, Sweden, and United States, for example). The extent of an underground economy is influenced by a number of factors, with the tax administration playing, at most, a minimal part.⁴ Obviously, the size of an underground economy adversely impacts the revenue of a country, which is why even the most advanced economies search for ways to reduce its size and widen their tax base.

There are some writings that would tend to imply that corruption has a positive impact on economic growth and revenue. These studies have hypothesized that bribery helps to “grease the wheel” to assist in the importation of crucial supplies or encourage the investment by multinational enterprises, thus positively impacting economic growth. Per these studies, tax revenue increases in certain situations involving corruption. In the article, “Fiscal Corruption: A Vice or a Virtue?” authors Fjeldstad and Tungodden (2001) explore this issue, ultimately drawing the conclusion that corruption is not a positive influence, no matter its short-term gains.

3.4 Enforcement

Corruption in other governmental institutions can have a significant direct impact on the efficiency or effectiveness of a tax administration. Many tax administrations depend on other governmental institutions for assistance in enforcement of tax laws. Perhaps a seizure or sale of assets seized for non-payment of taxes must be based on a court order. If the case is heard before a judge that is willing to accept a bribe, the tax administration is thwarted in its enforcement effort. Perhaps a bailiff is required to seize property of a taxpayer upon the request of the tax administration and pursuant to a court order. A bailiff that is willing to take a bribe suddenly may have difficulty finding any assets that could be subject to seizure. Perhaps a tax administration needs assistance in prosecuting a tax evader and passes its case to a public prosecutor. If the public prosecutor is willing to take a bribe, the case may sit for an inordinate period of time before being brought to trial, the case may be presented in such a way as to ensure that the defendant is found not guilty, or the prosecutor may return the case to the tax administration based on

a determination that there is insufficient evidence to pursue the case in court. Over a period of time, if these events frequently repeat themselves, the tax administration stops attempting to enforce the laws—or at least stops resorting to certain methods of enforcing their laws. In some cases, this could result in the tax administration taking matters into their own hands and undertaking actions that are outside their authority to take—thus adding to the cycle of corruption and causing a previously honest tax administration to become corrupt under the guise of actions necessary to enforce the law.

4. Anti-corruption Measures: Systemic and Behavioral

A great deal of effort is being expended by donor organizations to address corruption in governmental institutions, including tax administrations, particularly in underdeveloped or transition countries.⁵ In earlier years, these efforts attempted to deal with corruption by addressing systemic issues, primarily directed at the lower-level administrative corruption, without giving appropriate consideration to the corruption imbedded in the political systems at the highest levels of government—grand corruption. As a result, many of the early efforts were not successful or the results achieved were not sustained over a long period of time. For more on this topic, see USAID 2005.

A World Bank PREM Note distinguishes strategies for combating corruption in a tax administration between motives (behavioral) for corruption and opportunities (systemic) for corruption (World Bank 1999). The PREM Note outlines a variety of approaches to address both the motives for corruption and the opportunities for corruption. It also analyzes the use of those approaches in conjunction with World Bank projects in Latvia, Guatemala, and Tanzania.

4.1 Mission and Values

Many anti-corruption efforts begin with a review of the tax administration mission, vision, and values. Those statements reflect the primary objectives of the tax administration and what it stands for, creating the foundation documents from which other documents, such as a Code of Conduct, will flow.

Establishing a Code of Conduct establishes the minimum standards of employee conduct that will be accepted by a tax administration. The Code of Conduct will generally address such items as gifts or gratuities, employment outside the tax administration, employment of close relatives, professional conduct on the job, timely payment of debts, sexual harassment, confidentiality of tax information, unauthorized access of tax information, unauthorized use of tax information, criminal acts on or off the job, and other standards of conduct deemed appropriate for employees in public service positions.

Employees must be aware of the provisions of the Code of Conduct from the day they begin their employment with the tax administration. Most tax administrations require the employee to sign a document acknowledging receipt of the Code of Conduct as part of the entry on duty process.

4.2 Code of Conduct and Standards

Enforcement of the Code of Conduct and other standards of employee conduct is an integral part of any anti-corruption effort. Tax administration officials at all levels of the organization must understand and be aware of the consequences of violating the Code of Conduct and standards of employee conduct. Some tax administrations have their own unit to investigate allegations of employee misconduct, while others must rely on external investigative functions. Lack of effective enforcement of Codes of Conduct is a factor in the level of corruption in a country—revenue officials measure the benefits of corruption against the costs/potential of being caught.

An effective internal audit function is an important factor in actually discovering corruption or in identifying practices or systems that have a high degree of risk. The internal audit function also provides oversight to determine if management controls are in place or are effective. An internal audit can identify areas in which policies or procedures are not being followed. Such oversight is another factor that a potentially corrupt official must weigh in measuring the benefits of corruption against the potential of being caught.

In the United States, the function for investigating matters involving employee conduct was part of the tax administration for nearly 50 years. In 1998, Congress determined that the function was too closely associated with the tax administration and, therefore, was not sufficiently objective in its investigations of misconduct, especially misconduct allegations involving high-ranking officials. As a result, the investigative function was transferred to the Treasury Department, the cabinet-level department of which the tax administration is a part, creating the Treasury Inspector General for Tax Administration (TIGTA). As the name implies, TIGTA deals only with tax administration issues. Included in Annex 2 is a description of the strategies employed by TIGTA. These misconduct cases are largely illustrative of petty corruption in tax administration, along with summaries of cases recently investigated.

4.3 Income and Wealth Statements

Along with the Code of Conduct, many tax administrations require tax officials to submit annual statements of income and wealth. In some tax administrations, these annual statements may be required of all tax administration employees, others require only high-level

senior officials to submit annual statements, and yet others fall somewhere in between. As in the case of the Code of Conduct, these statements are valuable in fighting corruption only if something is done with them. Occasionally, tax officials will react to the reporting requirement by placing assets in names of relatives or other nominees, an offense in itself. Persistent investigation and follow-up is required to ensure that the statements accurately reflect the tax official's financial situation. Because of the large number of tax administration employees, it is generally not feasible to verify all annual statements, so the reporting requirement is limited to those in positions of greatest risk of corruption.

4.4 Hotlines

Establishing “hotlines” for citizens to report allegations of employee misconduct is a frequent part of an anti-corruption strategy. The hotline is usually directed to the function in the tax administration responsible for investigating these allegations. The existence of the hotline and assurances of confidentiality must be widely publicized in order to gain citizen support in the effort against corruption. In some cases, citizens may have their allegations published in the news media. In the extreme, citizen discontent with the level of corruption in a tax administration may result in a level of protest and civil disobedience that cannot be ignored, forcing the government to take action against corrupt tax officials. Without the involvement of the citizens of the country in demanding an honest government (including the tax administration) and demanding that government have the political will to eliminate corruption, most efforts to curb corruption will be unsuccessful.

4.5 Organizational and Management Techniques

To address the increased potential for corruption generated by familiarity with taxpayers, tax administrations establish policies for rotating staff among offices or between similar positions. Where rotation is not feasible, there may be a policy that an individual cannot audit the same company more than a certain number of times in a specified period of time, with a different auditor to conduct the audits of that company once the initial auditor has reached the maximum number of audits. The frequency of rotation is a decision to be based on considerations of the disruption caused by rotations, employee considerations, needs of the tax administration, etc. In countries where patronage is a factor in human resource decisions, rotation of staff can create its own form of corruption in which employees pay high prices for more attractive posts.

4.6 Autonomous Administration

Many countries have attempted to deal with the systemic causes of corruption in a tax administration by creating an autonomous revenue administration. The concept behind the establishment of autonomous revenue administrations is that removal of the tax administration from the constraints imposed by civil service regulations related to pay and employment will give the tax administration more flexibility in hiring and firing employees, as well as more flexibility in establishing pay scales. The argument is that without these flexibilities, the tax administration will be unable to fire corrupt employees and that higher pay will eliminate one motive for corruption. The results have been somewhat mixed. The Tanzanian experience seems to demonstrate that gains can be made in the early years, but old networks of corruption may resurrect themselves (Fjeldstad 2002).

The effectiveness of higher wages in combating corruption is subject to some question. In some cases, the higher wages have only resulted in better-paid corrupt officials. This seems particularly true in countries where the potential for discovery or the potential for severe sanctions were minimal (Fjeldstad 2005).

4.7 Simplified Rules

Simplification of tax rules and regulations is another means by which corruption is addressed. More complex tax laws that require interpretation by tax officials are often areas that generate opportunities for corruption. Where rules are interpreted differently for different taxpayers dependent on the amount of bribe paid for favorable rulings, there is minimal transparency, which in itself is a factor in the level of corruption in a tax administration. Many reform projects aimed at reducing corruption address the systemic issue of complex rules and regulations, with the goal of simplifying laws to the point that taxpayers understand them and there is minimal room for different interpretations. As previously noted in this paper, certainty in tax administration is a feature that all taxpayers desire and support. Simplified laws generally result in greater certainty and fewer opportunities for corruption.

In addition to efforts to simplify rules and regulations, reform efforts are also directed at reviews of systems and processes to identify and reduce opportunities for corruption. The more contact the tax administration has with the public, the greater the opportunities for corruption. This creates somewhat of a dilemma in that the public demands service while the tax administration may be attempting to revise the method of delivering that service in order to reduce the opportunities for corruption. The tax administration must determine what is an acceptable level of risk in designing its systems and include methods of discovering corruption in the design if it does exist.

4.8 Outsourcing

Private management of tax administration or some portion of a tax administration has been suggested as a possible means of addressing corruption in developing countries where corruption is particularly significant.

However, historical evidence and recent experiences from Africa, for instance Mozambique, give reason for concern: Such reforms have achieved few lasting results—the transfer of skills by foreign contractors has been limited and the contract has been very expensive for the government. Tax practitioners are therefore increasingly questioning the value of outsourcing tax administration (Fjeldstad 2005).

There is also the question of why private tax administrators would be any less likely to be honest than the tax administration officials they replaced. This is particularly true if local contractors are used.

The OECD (Organisation for Economic Co-operation and Development) has taken a proactive approach relative to corruption, particularly bribery of public officials. The OECD has developed a convention against bribery in which signatory countries (including all OECD countries and some non-OECD countries) are required to make bribery of foreign officials a criminal offense. In addition, the OECD has encouraged member countries to disallow tax deductions for bribery of officials (OECD 2006b).

5. Summary

Corruption cripples democracy. Perceptions of rampant corruption contribute to public disillusionment with democracy. Corruption undermines both the legitimacy and effectiveness of new democracies. It undermines democratic values of citizenship, accountability, justice, and fairness. It undermines free speech and public accountability, particularly when it reaches into the media sector and limits freedom of information. It violates the social contract between citizens and their elected representatives, and elevates the interests of the few over the many (USAID 2005).

Corruption in a tax administration is no less pervasive. The negative impact of corruption on voluntary compliance severely restricts the ability of the tax administration to deliver the revenue needed by the government to fund social and infrastructure commitments.

Addressing corruption in a tax administration requires a multi-faceted approach. While this paper has discussed a variety of approaches to the question of corruption in a tax administration, it must be stressed that rarely will any one approach be sufficient to address corruption unless it is isolated in a particular unit or process. A number of actions will be necessary, the most important being commitment from top management

and government leaders. Whether justified or not, perceptions both inside and outside the tax administration, must be addressed in any successful effort to eliminate corruption and gain the commitment and trust of the public and those tax administration employees who want to do the right thing.

With a determined leadership, committed employees, and a selection of the approaches appropriate to the existing environment, overcoming corruption is possible. However, in most cases, the results will not be seen overnight, but will require a significant period of time to achieve. Once success is achieved, it is necessary to have proper systems and checks in place to ensure that the success is maintained.

Annex 1.

Definitions

Self-assessment: A process through which the taxpayer assumes responsibility for determining and reporting his/her tax liability based on the provisions of the law and regulations. This is compared to a tax system in which the taxpayer submits income and expenses and the tax administration determines (assesses) the tax due.

Tax Avoidance: The application of tax laws in a manner that minimizes the amount of tax due.

Tax Evasion: Fraudulent or illegal means of underpaying or underreporting of tax due.

Voluntary Compliance: Taxpayer assumption of responsibility for submitting correct tax returns, correct tax declarations, and correct information with respect to tax liabilities voluntarily and voluntarily making payment of tax liabilities on time and in accordance with prescribed rules and regulations.

Annex 2.

US Treasury Inspector General for Tax Administration (TIGTA) Approaches (All below information extracted from www.ustreas.gov/tigta)

TIGTA protects the Department of Treasury's ability to collect revenue owed to the Federal Government. In order to achieve this, TIGTA's Office of Investigations (OI) administers investigative programs that protect the integrity of the Internal Revenue Service (IRS) and detect and prevent fraud and other misconduct within IRS programs. This includes investigating allegations of criminal violations and administrative misconduct by IRS employees, as well as protecting IRS against external attempts to corrupt or threaten its employees.

TIGTA's oversight extends to the IRS, IRS Chief Counsel, and the IRS Oversight Board. TIGTA serves as an independent voice reporting directly to the Treasury Secretary and Congress.

TIGTA OI conducts a comprehensive investigative program. OI's investigative program focuses on three main areas of concern:

- **Employee Integrity**

IRS employee misconduct undermines the IRS's ability to improve taxpayer customer service and effectively enforce tax laws and collect taxes owed. TIGTA investigates employee misconduct allegations including extortion, bribery, theft, taxpayer abuses, false statements, and financial fraud, as well as contractor misconduct and fraud.

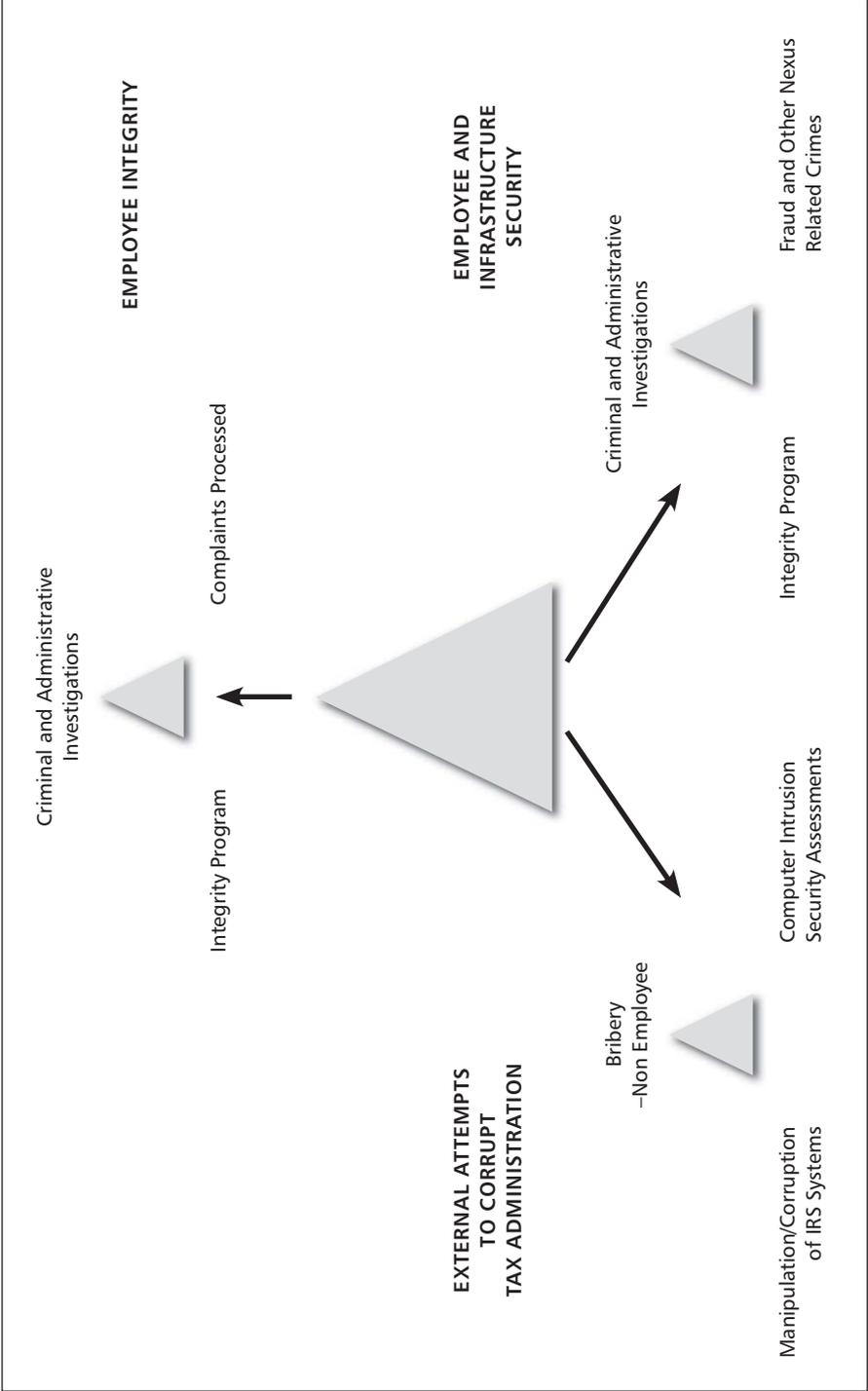
- **Employee and Infrastructure Security**

TIGTA is statutorily required to protect tax administration because of the critical role the IRS plays in collecting nearly two trillion dollars in revenue for the US government. This unique statutory mandate sets it apart from other federal Offices of Inspector General. As such, TIGTA must help protect the IRS's ability to collect tax revenue by ensuring IRS employee safety and infrastructure security.

- **External Attempts to Corrupt Tax Administration**

TIGTA is dedicated to investigating external attempts to corrupt or interfere with the administration of Internal Revenue laws. External attempts to corrupt tax administration include bribes offered by taxpayers to compromise IRS employees; the manipulation of IRS systems and programs through the use of bogus liens and IRS financial reporting instruments; the use of fraudulent IRS documentation; and impersonation of IRS officials. External attempts to corrupt tax administration inhibit the Treasury's ability to collect revenue and undermine the public's confidence in fair and effective tax administration—the two key facets of the IRS Strategic Plan.

Figure A2.1
Treasury Inspector General for Tax Administration Performance Model—TIGTA's Investigative Mission



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Notes

- ¹ “The objective of the global level playing field is to achieve high standards of transparency and information exchange in a way that is fair, equitable and permits fair competition between all countries, large and small, OECD and non-OECD. All countries, regardless of their tax systems, should meet such standards so that competition takes place on the basis of legitimate commercial considerations rather than on the basis of lack of transparency and lack of effective exchange of information. In particular, it is important to prevent the migration of business to economies that do not engage in transparency and effective exchange of information for tax purposes” (OECD 2004).
- ² “Corruption undermines social cohesion and broad participation in economic and political life by distorting the allocation of resources and the delivery of public services, usually in ways that particularly damage the poor. It also damages prospects for economic growth by reducing foreign direct investment, skewing public investment, encouraging firms to operate in the informal sector, distorting the terms of trade, and weakening the rule of law and protection of property rights. In doing all this, corruption fundamentally weakens the legitimacy and effectiveness of new democracies” (USAID 2005).
- ³ “Taxpayers suspect that a high proportion of taxpayers evade tax and regard this as appropriate behavior, while they personally disapprove of such behaviour. This constellation is problematic for two reasons. First, there is the risk that the misperceived social norm exerts pressure on people to disregard their personal beliefs and evade tax. Second, for those taxpayers who themselves would prefer to evade taxes, the high perceived prevalence of tax evasion provides them with a justification for doing so. The concept of ‘pluralistic ignorance’ captures the first of these two possible processes. It refers to the phenomenon that people misattribute other people’s behaviour through failing to realize that the same social pressure that determines their own behaviour may also determine the behaviour of others (Miller & McFarland, 1987). With regard to tax evasion, a perceived high prevalence of tax evasion would be attributed to other people’s conviction that tax evasion is acceptable, if not appropriate, behaviour. In turn, this social norm would exert some pressure to conform and evade tax as well. In doing so, one contributes to the general impression of widespread evasion which others, due to pluralistic ignorance, again attribute to moral conviction rather than to social pressure. There is thus a positive feedback loop of misattribution and conformity. An intervention to increase tax compliance could try to break the feedback loop and give taxpayers information about the true moral convictions in the taxpayer community (cf. Schroeder & Prentice, 1998). It could demonstrate the discrepancy between personal beliefs and beliefs attributed to the collective (pluralistic ignorance) and instigate a reappraisal of the situation” (Wenzel 2001).
- ⁴ “This demand for illegality may often be derived from the costs involved in legal registration and establishment, and the behaviour of the bureaucracy in their legal capacity. Legality represents considerable fixed costs. De Soto (1989) describes this process for a number of enterprises in Lima, making it obvious that the relative size of the underground economy must be expected to be larger in poor countries. He also finds that illegal establishments have to pay a much larger fraction of their net income in bribes compared to legal ones.

Nevertheless, corruption also causes firms to go underground. In an extensive empirical study of the size of the underground in 69 countries, Friedman et al. (2000) claim that corruption, rather than tax rates, is the main determinant of the size of the underground economic activities. In most of these observations the share of the underground economy varied between 10% and 70% of the total economy. Furthermore, with the partial exception of the group of transition countries, the incidence of perceived corruption appears to increase with the share of the underground economy” (Andvig et al. 2000).

- ⁵ “A major factor contributing to the failure of many tax administrative reforms, which is also the case for many other types of public sector reforms, has been the ‘technocratic’ approach taken by reformers and donors. Tax administrative reforms in poor countries have often been treated as an ‘engineering problem’—and as such a phenomenon to be addressed through ‘blueprint’ or ‘textbook’ solutions. [...] This accounts for the prescribed and mechanical approach usually favoured by donors, featuring quantitative performance targets, redrawing of organisational charts, rewriting job descriptions, training courses for tax officers, installation of new systems for human resources and financial management systems, etc. Robert Klitgaard refers to this as the ‘more approach’ (or the supply side approach)—i.e. more training, more equipment, more technical assistance, etc. Such strategies may be necessary, but if the demand side of administrative reforms is being overlooked, this may lead to distorted incentives through technical assistance, and also to undermining the government’s commitment to civil service reforms. [...] The technocratic approach has often overlooked the fact that reforming a tax administration—though it has important technical aspects—is also a social and political phenomenon driven by human behaviour and local circumstances. It is a long and difficult process that requires tax officers to change the way they regard their jobs, their tasks, and their interaction with taxpayers. The technocratic remedies supported by donors have underplayed the degree to which progress in [tax] administration depends upon thorough ‘culture change’ in the public service” (Fjeldstad 2005).

Transparency of Intergovernmental Transfers

Gábor Péteri

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Abstract

This chapter on fiscal transparency takes into consideration that national budget grants and shared revenues are significant sources of revenue for local governments. Thus fiscal transparency is strongly influenced by the scale, methods, and techniques of allocating intergovernmental fiscal transfers. Ideally, national budget transfers should be predictable and objectively defined in order to provide a stable revenue base for localities. They are set during the budgeting process, so local governments have to be informed about planning rules about how the total amount of grants and shared revenues are calculated. The chapter continues by looking at the way in which transfers and shared revenues are allocated to regional governments, municipalities, or deconcentrated units of government. It recommends that transparency and accountability can be increased by introducing preset formula based on objective indicators for fund allocation. This would require sound statistical information, which is not subject to government discretion. The chapter identifies the success of objective formula-based grant allocation schemes to help identify the winners and losers of discretionary politicized decisions, so they will lead to greater equity and higher efficiency in using public funds. The chapter also suggests that transparency will also change the political discourse over public budgets, by making negotiations over municipal funding more focused.

1. Introduction

Much of the money that is spent on vital public services at the local level comes from grants, transfers, and shared revenues from the national government.¹ In Europe, the majority of municipal funds originate from central budgets and special, extra-budgetary funds (health insurance, environmental funds, etc.). In countries that belong to the European Union, funds are also transferred from the EU level to sub-national governments directly and via programs controlled by the national governments.

Even in countries of Western Europe, fiscal transfers are significant parts of local budget revenues. Some countries with decentralized public services like the Netherlands or Germany heavily depend on fiscal transfers (Table 1).

Table 1.
Fiscal Transfers in Percentage of Local Revenues²

Country	[Percent]	Country	[Percent]
Italy	65	Belgium	46
Netherlands	62	Austria	39
Greece	60	Luxembourg	37
Spain	59	France	25
Germany	55	Finland	23
Portugal	49	Denmark	18
Ireland	47	Sweden	13

Source: Dexia. 2004. *Local Finance in the 15 Countries of the EU*. Paris: Dexia.

In other countries reallocation of shared revenues (primarily VAT and personal income tax) complement the transfers from higher levels of government. In some of the new EU member states—mostly in the Baltic countries—shared taxes are significant sources of municipal budgets (Table 2). Especially in these countries, grant allocation schemes and tax-sharing arrangements are the critical conditions of local autonomy.

They are significant revenue sources at the local level, so the scale, methods, and techniques of allocating intergovernmental fiscal transfers have a strong influence on fiscal transparency. These transfers must be kept transparent, because they define the openness that needs to be maintained on the national and local level. However, these regular grants, mostly allocated for current budget purposes, rarely attract the attention of the media or civic groups watching budgets.

Table 2.
Shared Tax Revenue and Grants in Percentage of Local Revenues³

	Total of Shared Taxes and Grants	of this	
		Shared Taxes	Grants
Lithuania	88	78	10
Estonia	81	43	38
Czech Republic	76	41	35
Latvia	74	46	28
Poland	72	13	59
Slovenia	63	42	21
Hungary	60	16	44
Slovakia	52	33	19

Source: Dexia. 2003. *Local Finance in the 10 Countries Joining the EU in 2004*. Paris: Dexia.

As intergovernmental fiscal relations are dominated by centrally allocated funds in most countries, primarily the *method of allocation* but not the scope of grants is what really matters for local governments. The basic questions, which are important for municipalities are the following ones:

- How much money is transferred from national budget to the local level?
- In what way are these funds allocated to sub-national governments?
- How much autonomy is left for local governments in spending these transfers and shared revenues?
- How transparent is this entire process of grant allocation?

2. Fixing the Total

Municipalities need relatively stable revenue sources for financing the services provided regularly at the local level. This stability can be achieved only if the amount of intergovernmental transfers is predictable and objectively defined during the budgeting process. Local governments should be informed about the *planning rules* on how the total amount of grants and shared revenues are calculated in the process setting the macroeconomic fiscal targets. By making transparent the regulations on planning the aggregate funds for local governments, the municipalities will be able to design their long-term spending priorities and projects more effectively.

There are three ways to determine the total amount to be transferred to sub-national governments: (i) as part of the GDP or the annual national budget; (ii) as a fixed share of national government revenues; (iii) as a proportion of approved specific local expenditures to be reimbursed.

The first model—linking grants to *overall economic indicators*—is rarely used in transition countries, because in the period of economic recession local governments would suffer from a sudden decrease in transfers received. In other cases, like in Serbia in 2007, where the grant pool is defined as 1.175 percent of GDP, economic growth and changes in the method of calculating GDP has brought about windfall revenues for the local government sector. As a response the national government tried to force local governments to spend these extra revenues on new services assigned to them. In other models, for example, in Poland, only a sub-set of intergovernmental transfers, the grant for public education, is determined as a specific share of the national budget.

The other method—when transfers are expressed in *percentages of major national taxes*—ensures both predictability and buoyancy of local government grants. Mostly VAT or personal income taxes (PIT) are used for these purposes. The issue is whether the ratio is set by law for a longer period (e.g., four percent of VAT is allocated for equalization grants in Macedonia) or only for a shorter period (e.g., for at least one election cycle, like in Hungary, where 40 percent of PIT is always shared with local governments and 80 percent of this fund is allocated as a general grant).

Under the third method—when transfers are provided as *matching grants*—the total amount of transfers is usually based on the estimated local expenditures. In this case transfers are set in closed-ended funds, or the local needs are prioritized and spread over several years, if the demand exceeds the funds available in the annual budget. This form of fund allocation guarantees the lowest level of transparency.

However, intergovernmental transfers have to take into account various policy goals. So the total amount of grants also depends on the *balance between* these different fiscal *policy objectives*. These aims are influenced by external factors, like the type of functions assigned to local governments (communal or human services) and the territorial-administrative structures.

Education and social/welfare services would need a higher level of centrally allocated funds than urban services partially financed by user charges. In fragmented local government systems—like those in the Czech Republic or Hungary—there is a greater need for equalization, because many of the smaller municipalities lack a sound revenue base. In countries with larger municipal units and consequently having a more stable economic base (e.g., Poland), municipal governments have more diverse and established own revenues, so they would need less intergovernmental transfers.

The amount transferred to local governments is determined by a compromise among competing fiscal policy concerns. Grants, shared revenues, and subsidies to local governments follow three basic objectives:

- a) providing *incentives* for efficient spending and utilization of the municipal revenue base;
- b) guaranteeing *sufficient* funds for managing local functions according to an agreed (or minimum) level of services; and
- c) supporting regional *equalization* of communities.

Decisions about fiscal policy must strike a balance between these three objectives, and priorities may change depending on the actual economic conditions. More restrictive fiscal policies focus on local incentives to increase municipal revenues and reduce expenditure. During leaner budget years, municipalities may call for fiscal guarantees to prevent any cutbacks in national grants. In a period of economic growth, more funds might be used for equalization between cities and villages, or among affluent and depressed regions. All these factors influence the total amount of funds assigned to local governments.

3. Moving from Discretion towards Formulae

Determining the total amount of local government transfers is only the first step in the budget planning process. The second basic issue is the way in which transfers and shared revenues are allocated to regional governments, municipalities, deconcentrated units of government, or even to service organizations.

3.1 Rules for Gap-filling

In the old communist regimes of Central and Eastern Europe and the former Soviet Union, locally provided services were financed through national funds, which were allocated in a highly discretionary way. The total budget appropriations were set during a *multi-level bargaining process*. The real allocation decisions during these negotiations were disguised by complex input indicators on labor, materials, and other costs of services. Current budget appropriations and capital investment programs were set by ministries. Even line ministries had limited influence on the allocation design led by the Ministry of Finance. So under this system—the Ministry of Finance being in a monopolistic position with highly discretionary powers and accountable only to centralized political power—allocation was not only ineffective, but the least transparent and prone to grand corruption.

Since the end of the communist era, the situation has been changing—even in the governments of Central Asia, where decentralization is moving more slowly. As a

first step in these countries, the various units of the executive, including ministries and regional governments, are trying to develop some agreed-upon principles to limit the discretion of national budget allocation. Central Asian governments find examples in Russia, where a complex formula is used to divide revenue allocation among the 89 entities at the federal level. Central Asian policymakers are also ready to imitate such practices as “the money follows the pupil,” wherein education is funded per capita.

These techniques are *improved variants of the gap-filling model*, widely used under the command economy. In this case the grant for the lower level of government (*oblast, rayon, or city*) is equal to the difference between estimated level of expenditure and the planned local revenues ($E-R=G$). However, the method of calculating the expenditure appropriations is more transparent; they are set by law and in principle cannot be manipulated by the executive.

These first steps can lead to more refined models of fund allocation: In Macedonia, the most recent fiscal decentralization reforms have introduced simple formulas for funding public education services through local governments. Local governments running primary schools get a “basic amount per municipality,” plus funds calculated on a per-pupil basis, weighted by population density coefficient. This is based on the assumption that unit costs of education are higher in sparsely populated areas with smaller schools. In order to keep the stability of school financing, no municipalities can get lower than 85 percent, or higher than 112 percent, of the amount they received in the previous year.

Transparency is further improved when funding for more services are incorporated in the formula and the allocation techniques become more sophisticated. In Slovenia, for example, the level of all local government expenditures is calculated by a transparent and objective formula. When calculating the expenditure of specific municipalities, planners factor in population, length of local roads, area of the municipality, population in school age, and the number of elderly. A formula is used to compare the per capita ratio with national averages, and each factor has a different weight. For example, a Slovenian municipality’s population is given the highest multiplying coefficient in the formula, with 70 percent.

3.2 Control over General Transfers and Equalization Funds

The above-mentioned grant formulas seek to fill the gap between estimated expenditures and calculated municipal revenues in a transparent way. Another model focuses on the transfers only, leaving the level of local expenditures entirely under municipal control ($E=G+R$). This method is used in the Czech Republic, Hungary, and Poland. In these Central European countries, *general-purpose grants* are allocated to local governments by *complex formulas*.

In Hungary, allocations for local governments are determined according to approximately 90 different basic indicators, each given different weights resulting in a very complex, sometimes complicated allocation scheme. Local governments have to be informed about several hundred grant allocation criteria.

In Poland, the general grant consists of two basic components. One component takes a fixed percentage of the national budget and divides it among local governments, based on the number of primary and secondary school pupils attending schools under their jurisdiction. The per-pupil amounts are weighted according to school type and pupil needs, to account for the differing unit costs of providing education under different jurisdictions. For example, rural schools may cost more to run than urban schools, and students with special needs or a foreign mother tongue may cost more to educate. All together, Poland uses 21 coefficients for deciding the size of education funding. Other factors in the formula determining the size of local transfers in Poland include the desire to equalize the revenue-raising capacities of local governments.

In countries of South Eastern Europe municipal finances are predominantly based on shared revenues, consequently grant allocation schemes are built on *revenue equalization formulae*. VAT is the best candidate for equalization (Bosnia and Herzegovina, Macedonia), despite the fact that local governments have no discretion over the tax rate and it cannot be measured at the local government level. Set percentages of national VAT is allocated to local government budget through various indicators showing the need for funding (e.g., population, number of young, or elderly population). In other countries like Albania, the four major local taxes (small business tax, simplified profit tax, vehicle tax, and property transaction tax) are pooled and compared to the national average. Local governments with a per capita revenue pool below average receive 35 percent of the missing part, while those with an above-average revenue pool subtract 35 percent of the difference from their unconditional grants.

3.3 Sound Information Base

All these complex formulas require proper statistical and fiscal information, otherwise there would be no way to ensure objectivity in grant allocation.⁴ Detailed data are needed on local government finances and on various performance or statistical indicators. Usually the latter ones are available from public databases; however, the measurement of outputs and the capacity of service organizations in a timely manner is not a simple task. Especially because this information is not always available at the early stages of annual budgeting, fiscal planning is often based on estimates and projections.

Local government expenditure and revenue data are usually provided by the fiscal information system. Even the most centralized public finance systems are able to produce some data by local governments. From the transparency point of view the questions are

whether this information is sufficiently accurate and to what extent it shows the real financial status and revenue capacity of a particular local government.

Public sector finances usually follow cash-based *accounting* rules. This is sufficient for controlling local government expenditures and revenues in a given planning or reporting period (typically monthly, quarterly, or annually). However, there are obligations on local government budgets, which go beyond the actual fiscal year, like municipal debts or guarantees issued to service organizations. There are also revenues receivable, for example, when user charges are collected by local governments. These figures and the net position of local government assets are reflected only in the accrual accounting or modified accrual accounting systems. So without having some information on the longer-term commitments of municipalities, their real financial position cannot be assessed and the transfers will not be able to take into account the real financial status of a particular municipality.

On the revenue side modern techniques of transparent grant allocation methods are usually hindered by the lack of *information on tax capacity*. This would require a good indicator of tax base and also detailed information on tax rates by types of municipalities. Alternatively, some estimates for assessing the tax base might be helpful as well. All this information should be publicly available, so local governments will be in a position to compare their tax efforts to other ones in a similar position. So transparency influences the effectiveness and equity of the grant allocation schemes.

The availability of fiscal information is important not only for the local governments and for the ministries directly involved in grant allocation, but for *policymaking* in general. When only the national government has access to data needed for designing intergovernmental fiscal transfer schemes, then this “planning monopoly” will hamper innovation and reforms. Local government associations, independent policy institutes, and even opposition political parties should be able to develop new models and test their alternative proposals. For example, in Hungary data on municipal budgets are public at local governments, but the fiscal information systematically collected by the treasury and the Ministry of Finance is not published in a manageable way. This makes the policy research on grant design and the benchmarking of local governments more difficult.

3.4 Capital Investment Grants

Another type of transfer, the capital investment grants, are usually highly debated elements of intergovernmental fiscal transfers. Local capital investments are typically funded through various sources, including national, municipal, and private funding, but national grants always play an important role. Transfers are allocated by discretionary decisions or through matching grant schemes. Despite the national strategies, sectoral

development plans, and feasibility studies, capital investment grants are always at a higher risk of politically biased decisions than grants for current expenditures.

After the accession, the first experiences with European Union funds were similar. Within the EU, an additional level of bureaucracy was created and new procedures for domestic planning, programming, and spending were introduced. These planning practices often *overwrite the existing regulations* on intergovernmental relations. Consequently, national development plans, operative programs, and EU grants should also be part of the fiscal transparency framework.

4. Importance of Transparency

Transparent budgeting procedures and open, legislated methods for distributing national transfers or shared revenues will have a positive impact on intergovernmental finances. The *objectivity* of grant allocation formulas limits the discretion and arbitrary character of central decisions. This will make the fiscal conditions of local governments more *predictable* and could increase the *stability* of fund allocation.

Beyond allocation methods, the scope of local *spending autonomy* in using the received transfers is also critical for accountability. The unconditional, general-purpose grants create incentives for efficient forms of service delivery and an increase in own source revenues. These grant allocation techniques are accompanied by sectoral and fiscal regulations, which could limit local powers in spending the general grants.

The proportion of various types of grants determines the level of local autonomy. Conditional grants are earmarked to tasks, groups of services (block grants), or specific types of expenditures (e.g., capital expenditures). In these cases local discretion over spending is limited. Transparency of these spending rules would make all the local stakeholders better informed and ultimately will improve the efficiency of local decisions.

Transparent grant allocation formulas at the national level clearly show the problems of discretionary decisions by *identifying the winners and the losers* in financing local public services. If equalization grant formulas are properly designed and general grants create local fiscal incentives, then they will lead to greater equity and higher efficiency in using public funds.

Transparency in municipal grant allocation would also change the political discourse over public budgets. Fiscal policy design will remain open, but negotiations over municipal funding will become *more focused*. As there are competing requirements towards intergovernmental fiscal relations, one transfer cannot meet all of them. Each method of grant allocation serves only a limited number of objectives, that is, the transfer system should have a singular focus.⁵ A good balance of the various techniques will support the mixed objectives. With transparent intergovernmental fiscal transfers, the policy options can be transformed into objective measures and their fiscal impact is easily measurable. This will make local government services more efficient and equitable.

Notes

- ¹ This chapter is based on my reports written for the *Local Governance Brief*, Summer 2006; “Intergovernmental Transfers” In: Robert D. Ebel and G. Péteri (eds). 2007. *Kosovo Decentralization Briefing Book*. Prishtina: Forum 2015/KFOS/LGI; “Fiscal Equalization in South Eastern Europe.” FDI papers. Budapest: OSI/LGI. Available online: http://lgi.osi.hu/publications_datasheet.php?id=346; and “Rationale and Models of Fiscal Equalisation in Europe.” Joint Initiative of EAR and CoE in Montenegro, 2007.
- ² Excluding borrowing.
- ³ Excluding borrowing.
- ⁴ Yilmaz, S. et al. 2003. *Subnational Data Requirements for Fiscal Decentralization*. Washington, D.C.: World Bank Institute.
- ⁵ Shah, A. 2006. *A Practitioners’ Guide to Intergovernmental Fiscal Transfers*. Washington, D.C.: The World Bank [WPS4039].

Access to Fiscal Information and Audit: Challenges and Strategies

Michael Schaeffer

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Abstract

Practical issues relating to effective public financial management ultimately govern whether or not there is good governance at the sub-national level—hence the success or failure of different policy options. Although there is a growing literature on decentralization, fiscal rules, and sub-national debt management, somewhat less attention has been paid to equally important and critical issues impacting public financial management—public sector accounting, internal management controls, public sector auditing, and directions for improving public sector information flows. This chapter focuses on effective public financial management and good governance via the instruments of accounting, internal control, and public sector auditing. Public sector accountability may not achieve its potential if not guided by coherent and universal principles: strengthening governance (accountability, transparency, predictability, and participation); reinforcing the foundation of civil society; and engaging in improvements in public expenditure management programs. In addition, programs to increase public sector accountability must carefully consider the country-specific context.

1. Introduction

The goal of improving government accountability and reducing inefficiency should not be viewed in isolation, but as part of the broader issue of governance and public financial management. The corrosive effect of inadequate government accountability is a logical extension of the link between governance and development. Aside from moral and legal considerations, there is solid evidence that the lack of accountability, transparency, and operational ineffectiveness distorts resource allocation, and invariably hurts the poor the most.

Strengthening government accountability and improving fiscal transparency is vital. Strong financial accountability means that people can affect their government's spending and taxation decisions. Citizens also need to take responsibility for the consequences of those decisions. Further, the financial system for government must reflect both the importance of accountability and the interests of central government. For example, a general public sector reform trend has seen the governments of most developed countries, and many developing countries, adopt some aspects of accrual accounting as the basis for their budgeting and reporting. There is no evidence that this trend is reversing.

Supporters of accrual accounting and budgeting argue that at the aggregate level, accrual-based fiscal indicators provide better information about the sustainability of fiscal policies, provide a stronger basis for government accountability, and provide a better measure of the effects of government policies on aggregate economic demand.¹ At the budget organization level, accrual-based financial statements generally provide better measures of organizational efficiency and effectiveness, and reduce opportunities for fraud and corruption. In addition, the auditing function (i.e., internal, external) can contribute in numerous ways to more effective management of government financial resources and fiscal transparency. In brief, auditing can detect irregularities and the misuse of government funds, determine the reliability of government information, and can provide reliable data regarding government program results as a basis for future budget adjustments and allocations.

Developing countries, however, confront obstacles that developed countries generally do not face including: human resource and other capacity constraints that can be overwhelming, corruption and vested interests that can undermine efforts, there may be more urgent needs than reforming the accounting and general budgeting fiscal transparency programs, and the various country-specific (Supreme) Audit Authorities may have limited capacity to undertake efficient external audit assignments. Excluding this brief introductory and concluding sections, this chapter is organized into four primary sections, including: (i) Role of Accounting and Financial Reporting, (ii) Management Controls; (iii) Public Sector Auditing, and (iv) Mechanisms for Improving Information Flows: Directions for Reform.

1.1 Role of Accounting and Financial Reporting

Accounting is the systematic gathering of financial transactions and the compiling and reporting of these transactions in a meaningful and consistent manner so that government decision-makers can measure progress towards goals established in the budget; estimate resources required to accomplish these objectives; and effectively allocate resources across competing goals and objectives. Accounting should be a relatively straightforward document-recording procedure with cash coming in and cash going out.

The Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) has identified seven objectives of governmental financial reporting. These objectives are as follows:

- Indicate whether resources were obtained and used in accordance with the legally adopted budget.
- Indicate whether resources were obtained and utilized in accordance with legal and contractual requirements, including financial limits established by appropriate legislative authorities.
- Provide information about how the government or unit financed its activities and met its cash requirements.²
- Provide information about the sources, allocation, and uses of financial resources.
- Provide information that is useful in evaluating the government's ability to finance its activities and to meet its liabilities and commitments.
- Provide information about the financial condition of the government or unit and changes to it.
- Provide aggregate information useful in evaluating the government's or unit's performance in terms of costs, efficiency, and accomplishments.³

Accounting is in fact a complex system of financial interactions that must be properly designed in order to function well and to provide decision-makers with effective management reporting information.⁴ The following sections provide a basic overview of some necessary features of an effective government accounting system, such as a chart of account and the basic principals of cash and accrual accounting are reviewed.

1.2 Unified Chart of Account

Accounting detail is important, but the sheer volume of transactions that may occur at the national and sub-national government level means that information regarding individual transactions must be collected and systematically classified. The chart of account represents the basic structure of financial accounting and must include all categories of

assets, liabilities, revenue and expenditures, and equity accounts of the public sector. A well-designed chart of accounts provides a logical structure for classifying financial transactions so that financial data can be viewed from a number of perspectives.⁵

In general, a single uniform chart of account accompanied by budget classifiers is necessary for a truly integrated accounting, budgeting, and local government financial management and accounting system. To facilitate consolidation and inter-regional comparisons, a central government will provide a standard chart of account⁶ to which all public sector budgeting units must adhere.

As the backbone of public sector finance, the chart of accounts is often ill-defined. In Croatia, for example, the Ministry of Finance, in its initial attempts at developing a chart of account, did not prescribe the classification of the budget by cost type or by function. Instead, expenditures were classified only according to administrative categories (i.e., budgetary beneficiaries and purposes) and no classification of expenditures in terms of programs, sub-programs, or categories or activities is provided.⁷ Obviously, in the Croatian example, the system initially allowed for only the most rudimentary analysis of the budget.

1.3 Why Are Strong Public Sector Accounting Systems Important?

The wide use of public sector accounting standards may be more difficult to gain acceptance than those for the private sector for a number of reasons, including: (i) the size and complexity of government activities has tended to engender a simplicity of approach to accounting; and (ii) governments have traditionally engendered a “we have always done it this way, why change?” approach to many administrative and managerial techniques. Accounting has been no exception.

National (and sub-national) governments are increasingly competing for international financial resources (capital). Strong accounting and public expenditure management systems provide a competitive advantage for governments that install and effectively utilize these systems. Without a strong accounting system based on International Public Sector Accounting standards (IPSAS) (or Generally Accepted Accounting Principles [GAAP]), information provided to private sector institutions (investors) will not be timely, relevant, complete, or comparable.

1.4 Cash Versus Accrual Accounting

One of the most fundamental decisions in designing an accounting system is the basis on which the transactions will be recorded. Several accounting methods are recognized by the International Federation of Accountants (IFAC): cash, modified cash, modified

accrual, and accrual. Basic elements of cash and accrual accounting are described in the sections below.⁸

1.5 Cash Accounting⁹

The simplest of all accounting procedures is to record cash transactions: how much is received; how much is paid out; and how much is on hand at the bank. In effect, revenues and transfers are not recorded in accounts until cash is received, and expenditures (or expenses in proprietary funds) and transfers out are recorded only when cash is disbursed. The benefit of cash-basis accounting is that it is relatively simple to implement, but where there exists a strong parallel encumbrance system, cash-basis accounting fails to adequately control local government transactions. The cash basis is not recommended by IPSAS because it usually gives a misleading picture of municipal accounts.¹⁰ For example:

- **Cash received as a loan** would be illustrated as revenue on the operating statement but not as a liability on the balance sheet.¹¹ To correct for this kind of transaction, most cash accounting systems recognize not only cash, but also other assets and liabilities arising through prior cash transactions. The accounting correction, however, does not alter the fact that at any point in time, outstanding obligations, in the form of contracts or purchase orders issued, are not reflected in the accounting records. Consequently, the available balance is overstated. This can lead to unwise local (municipal) expenditures and potential budget overspending.¹²
- **Governments operating strictly on a cash basis by way of example may ignore obligations** to vendors for services and goods received but not yet paid. This type of action effectively creates a floating debt outside the normal financial management system.
- **The treatment of costs that may have a multi-year benefit under a cash-basis accounting system may also be somewhat questionable.** For example, charging the full cost of an item against the budget in the first year of its use may overstate the expense in the first year, but understates the expense in subsequent years. This may lead to government decision-making that in the near term may appear good, but in the long term may be more costly.

Cash accounting typically makes no provision for transactions and adjustments that do not emanate from direct receipts and payments. Cash-based accounting systems do not present information regarding the value of stocks that are consumed during the fiscal year, or the stocks which still exist at the end of the year. This is because the accounts are not concerned with recording usage. Cash-based accounting systems are concerned

with cash outflow that has been paid for purchases. There are no stock adjustments, stock valuation, and stock measurements under a cash-based system. As a result, the real value of these stocks is not known, thereby giving rise to a number of issues including problems associated with carrying costs. In addition, these stocks can be lost by deliberate manipulations during day-to-day addition or deduction operations.

Important omissions are adjustments relating to changes in fixed asset values and changes in the value(s) of long-term debt. As a result, cash-basis accounting does not permit the preparation of a balance sheet illustrating the assets and liabilities of the public sector. This inability to present a balance sheet implies that the net worth of the public sector cannot be presented. Even such short-term assets and liabilities such as inventories, receivables, and payables will not typically appear in “cash-basis accounting” balance sheets because they are not accrued.¹³

Box 1 illustrates the potential difficulty of determining fiscal strategy solely based on cash information.¹⁴ In the Croatian case, relying on cash information might lead Croatian policymakers to tighten fiscal policy through reductions in sectoral (i.e., education, health) spending. Contrast this with the same situation in the US under accrual-based accounting. These two similar examples demonstrate that countries should be careful in taking decisions based on incomplete (i.e., cash information) only.

Box 1.

Accrual and Cash Information Are Complementary

A Comparatively Higher Cash Deficit (Croatia)

Some of the data published by the Ministry of Finance (MoF) may give a false impression of fiscal developments. Since the fiscal accounts continue to be presented on a cash basis, the figures suggest that the deficit rose in 2000 and continued to rise in 2001. But this increase actually reflects the repayment of arrears (i.e., payment of obligations accrued in earlier years). In accrual terms, the fiscal deficit has in fact been decreasing. In 2002, the cash presentation should not differ substantially from the accrual presentation since the bulk of arrears have been repaid.

—Croatian National Bank 2002

A Comparatively Higher Accrual Deficit (US)

Accrual-based financial reporting is critical for gaining a comprehensive understanding of the US Government's operations. For fiscal year 2001, our results were an accrual-based deficit of \$515 billion in contrast to a \$127 billion (cash) surplus reported last fall. The primary difference between the accrual deficit and the (cash) surplus is the recognition of expanded military retiree health benefit costs provided by the National Defense Authorization Act, which was signed into law on October 30, 2000, and other actuarial expenses. In fact, these expenses caused the government's future obligations to its military and civilian retirees to exceed the federal debt held by the public. As with other future obligations of the federal government, only accrual-based financial reporting provides this information in context to the public.

—US Secretary of the Treasury 2002

1.6 Cash-based Accounting Is Inadequate for Control Purposes

Cash accounting is not a complete accounting system and its internal control is very weak. In effect, it is not possible to control the usage of inventories during the year or to what extent the fixed assets have been used. However, this system assists public sector entities in fulfilling the budgetary control function. The budgetary control is concerned with ensuring that actual expenditures are in line with budgeted amounts and that the objectives and levels of activities envisaged in the budget are achieved. A government cash accounting system without the budget and financial regulation restriction(s) is inadequate for control purposes.

1.7 Accrual Accounting

To resolve many of the problems associated with cash accounting, accrual accounting¹⁵ has been advocated at various government levels. In order to understand what is actually happening in public sector financial accounts, there must also be records that relate revenues and expenditures not to the time in which the cash is received or the disbursement made, but to the period for whose benefit the transaction occurs. Financial recording according to the benefit period, instead of the period in which cash moves, is known as accruing (accrual accounting). Under an accrual system, revenues are recorded when the charge is effective, not when the cash is received.¹⁶ Expenditures are recorded when the obligation is incurred, irrespective of when the disbursement is made.

The accrual basis is applied somewhat differently in proprietary funds (full accrual) than in governmental funds (modified accrual) because expenses are being measured in proprietary funds while expenditures are the focus in government funds. In brief, an expense is an amount of resources used up during the accounting period. Specifically, expenditure is an amount of cash spent, or to be spent, during an accounting period. Since governmental funds do not account for capital and debt (they are accounted for in fixed asset and long-term debt account groups), expenditures, not expenses, are measured. In contrast to government funds, the concern in proprietary funds is with net income. Full accrual accounting records revenues when earned and expenses when incurred. In other words, expenses are recorded when a liability is incurred regardless of when an actual payment is made.

Accrued revenues are usually expended on the assumption that the cash owing will be received. In fact, there may be losses. Taxpayers may dispute the amount owed, and the terms of grants and other transfer payments may be changed after the local government has already budgeted and spent the money. Likewise, expenditures when originally recorded may be over or under the amounts finally determined to be due. Contingencies

should be provided for by means of reserves (contingency) accounts against ultimate losses and unrecorded liabilities.¹⁷ Accrual accounting involves changing three existing financial features of current government financial operations including:

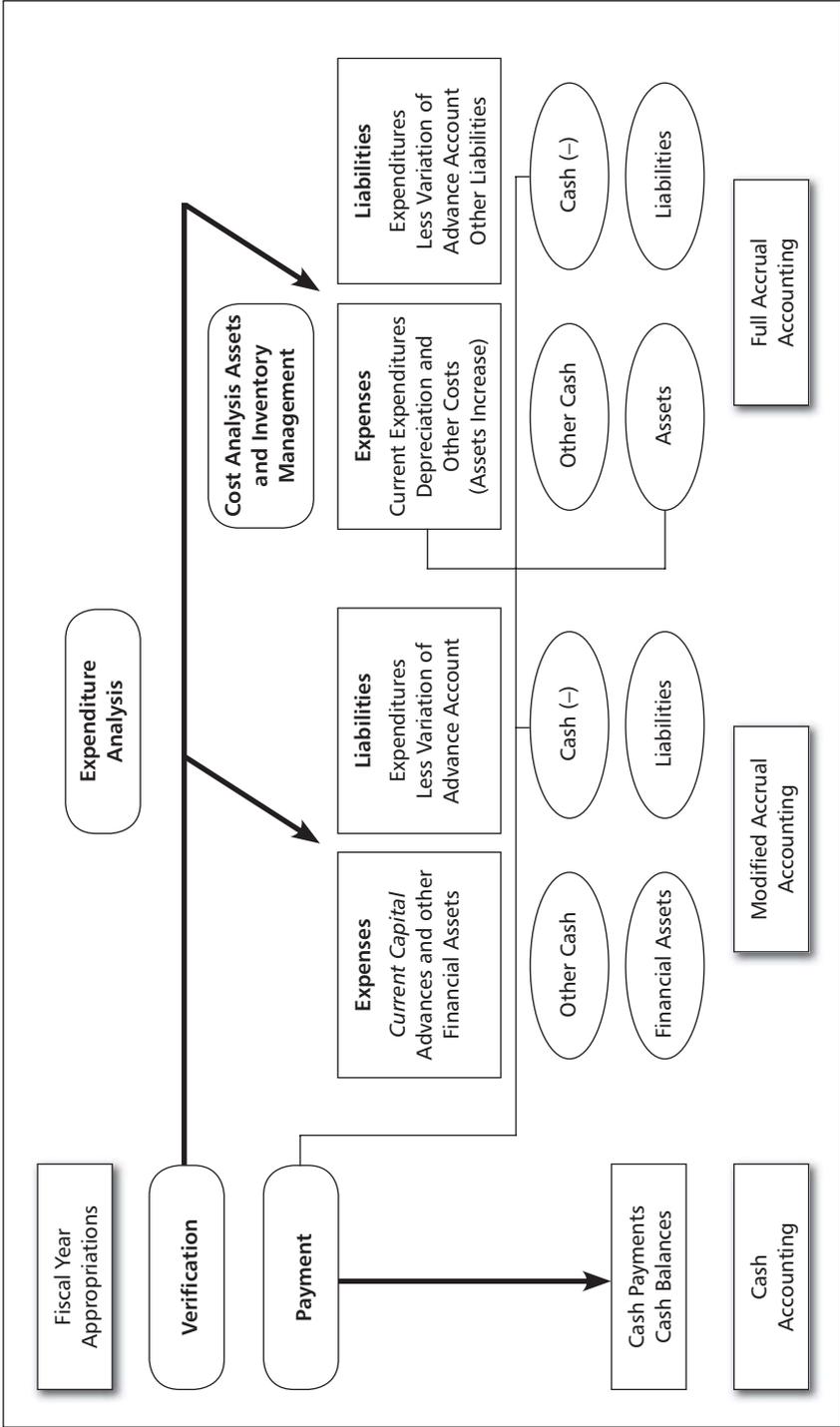
- Shifting the recording basis from cash to commitment;
- Separation of financial activities into current and capital, with full depreciation allowances that permit the allocation of costs over the life of the asset rather than recording the expenses when they are incurred; and
- Preparation of financial statements that are in conformity with International Public Sector Accounting Standards (IPSAS) (or Generally Accepted Accounting Principles [GAAP]).

Preparation of financial statements according to IPSAS (or GAAP) implies that governments must prepare a balance sheet, operating statement, statement of cash flows, and a statement of commitments and contingent liabilities. These statements will enable the public sector to understand its net worth and provide the basis for making future investment decisions.¹⁸ Figure 1 presents the basic dynamics of the cash, modified, and accrual accounting dynamics. Under the accrual system, incomes are reported in the fiscal year that they are earned, regardless of when payment is received, and expenses are recognized in the fiscal year that they are incurred, regardless of when payment is made. Under cash-basis accounting, incomes are reported in the fiscal year that they are received and expenses are deducted in the fiscal year that they are paid. All budget organizations must choose one or the other accounting methods.

It is important to understand the basics of the two principal methods of keeping track of an organization's income and expenses: the cash method and accrual method. In brief, these methods differ only in the timing of when transactions, including when sales and purchases are credited or debited to the accounts. The cash basis is much simpler, but its financial statement results can be somewhat misleading in the short term. The accrual method is the more commonly used method of accounting in the private sector, whereas the public sector has traditionally used the cash method.

Some organizations use a modified cash basis of accounting which is a hybrid method that combines features of both the cash basis and accrual basis. Modifications to the cash-basis accounting include the capitalization of assets. The resulting balance sheet would include long-term assets and accumulated depreciation. The income statement under a modified accrual system would include depreciation expense. Modified cash-basis financial statements are intended to provide more information to users than cash-basis statements, while attempting to avoid the complexities of full application of accrual accounting under IPSAS.

Figure 1.
Cash and Accrual Accounting Options



Source: Allen and Tommas. 2001. *Managing Public Expenditures*. p. 295.

1.8 Few Countries Have Implemented Full Accrual Accounting

To a varying degree, many countries have implemented accrual accounting in the past decade. But to date, only four OECD countries appropriate resources on an accrual basis.¹⁹ Others, including Canada and the UK, have rapidly moved towards appropriating resources on an accrued basis. Implementing accrual basis accounting requires fundamental legal changes. As a result, widespread adoption will take significantly longer to achieve.

Matheson (2002) indicates,

... that extending accruals to budget is controversial. Much of the controversy arises from the government administration itself and Parliaments. Before this change is contemplated, a significant amount of time needs to be invested in educating and consulting with government managers and other interest groups, like Parliamentarians. In those countries that have adopted accruals, the change has been linked to other public management reforms. Accrual accounting policies places a premium on confidence audits and a willingness to accept fluctuations in valuations. Practice in Australia and New Zealand has shown that the use of accruals in the budget has led to a better realization of future unfunded liabilities, better infrastructure management and more efficient budget reallocation process.²⁰

1.9 Implementation Is Difficult and Costly

Some aspects of accrual accounting and implementation are more difficult than cash implementations. For example, a government budget organization is unlikely to know the full amount of tax revenue that it is likely to receive at any given time. Furthermore, operating an accrual accounting system can be expensive. Many countries have developed their own “organic” computer systems to support cash accounting rather than rely on commercial accounting systems (with accrual accounting capability). The development of organic systems may prove over time to be more costly to develop and implement.

2. Management Controls²¹

The International Organization of Supreme Audit Organizations (INTOSAI) defines public sector management controls as all the policies and procedures needed by an organization to ensure:

- Economical, efficient, and effective achievement of the entity’s objectives;
- Adherence to external rules (i.e., laws, regulations, procedures) and to internal management polices;

- The safeguarding of assets and information;
- The prevention and detection of fraud and error; and
- The quality of accounting records and the timely production of reliable financial information.²²

Management controls are essential to effective management of budget organizations. Every country must determine the nature and extent of the management controls that it wishes to implement. Management control systems must not conflict with the overall management philosophy of the budget organization. Over the past decade, a new public management (NPM) paradigm has evolved where emphasis is now given to allowing discretion to line-managers for making decisions, and hold them accountable for results, rather than adhering to a system of strict rules and procedures. Havens (1999) indicates that the new public management philosophy can be easily vitiated by systems of management control that put undue reliance on detailed procedural safeguards or on multiple levels of supervisory review of decisions.²³

Box 2 presents detailed INTOSAI management control standards that should be the foundation of any public sector management system. Management controls are the responsibility of the management (leadership) of the organization to design and implement. If the leadership of an organization is committed to effective management, the next requirement is an assessment of the risks that affect that organization.

Box 2.

INTOSAI Management Control Standards

General Standards

- Management control structures exist to provide assurance that the general objectives of the organization will be accomplished.
- Specific control objectives are to be identified for each ministry/department/organization.
- Managers are to monitor their operations on a continuous basis.

Detailed Standards

- Management control structure of all transactions should be clearly documented.
- Transactions are significant events are to be recorded properly and promptly.
- The same person should not hold key duties and responsibilities in more than one of these areas: authorizing, processing, recording, and reviewing transactions.
- Access to resources and records is to be limited to authorized persons who are accountable for their custody and use.

2.1 Enterprise-wide Risk Assessment

Risk assessment may be defined as “an enterprise-wide approach to identify and analyze issues that affect the organization’s ability to meet its goals and objectives. Issues that may impact the organization’s ability to meet its goals and objectives are divided into several categories: strategic, financial, operational, compliance, and reputational.”²⁴ In general, risk management must be integrated into every facet of an organization’s operations as a routine operation.

The most important task confronting the leadership of a national (sub-national) government and its management team is to establish a risk management strategy and promote its use (benefits) through the organization. Figure 2 presents the basic risk management and management control process. The primary entity objectives in analyzing and managing risks that might impact the community include:

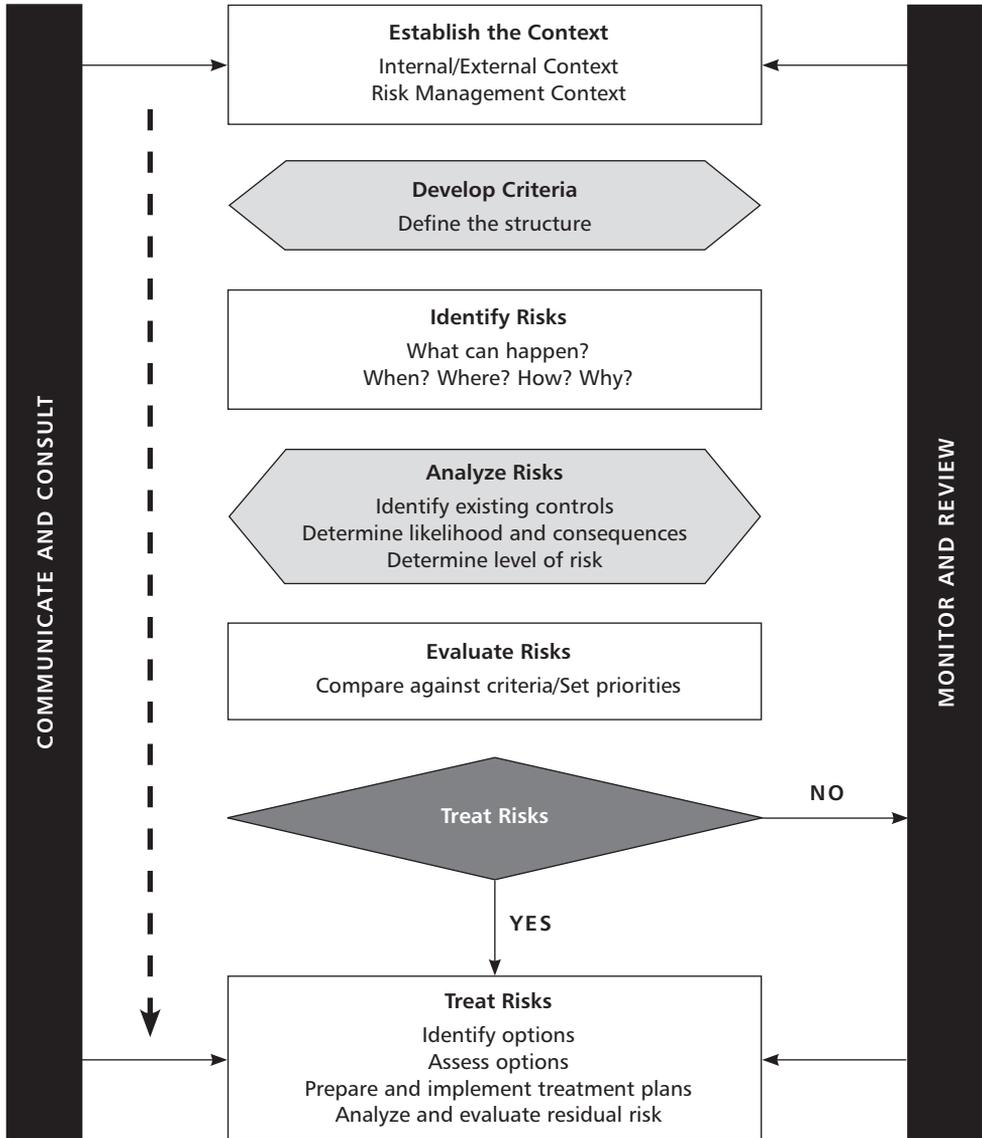
- Identifying and managing existing and new risks in a planned and coordinated manner with a minimum of disruption and cost.
- Develop a risk-aware culture that encourages the leadership (and employees) of the national (or sub-national) government to identify risks and associated opportunities, and to respond to them with cost effective actions.
- Be perceived by stakeholders to be adopting the best risk management and legally compliant practices.

Each department, or directorate, should examine its own operations to identify the risks that they currently face or expect to confront in the near, medium, and long term. This risk profiling exercise should enable departments, or directorates, to rank each risk in order of probability and severity, thereby enabling them to devise an action to tackle each risk based on its significance to the operation of the service. A budget organization (department, directorate) has a number of ways in which it can effectively manage risk, including:

1. Accept the risk and make a conscious decision not to take any action.
2. Accept the risk but take some actions to lessen or minimize the likelihood or impact.
3. Transfer the risk to another organization, for example, by outsourcing the activity.
4. Finance (or insure) against the risk.
5. Eliminate the risk by ceasing to perform the activity causing the adverse risk situation.

How a budget organization (department, directorate) decides to manage individual risks is determined by following a risk assessment based on a systematic analysis of how a number of likelihood and consequence²⁵ ratings apply to each risk.

Figure 2.
Establishing a Risk Management Strategy



Source: Author.

2.2 Developing and Maintaining an Effective Financial Control Environment

No accounting (and budgeting) framework is satisfactory from the point of view of fool-proof financial control. Pure cash accounting is unsatisfactory because it covers only those operating transactions that involve actual cash payments. This means that to set budgetary authorization limits in pure cash terms would be to give departments the scope for short-run evasion of financial controls by incurring expenses that involve future cash payments. Developing effective management controls in this area requires redesigning the management control structures and modifying the cash (and accrual) accounting system to increase the potency of financial controls.

2.3 Financial Control Versus Departmental Managerial Autonomy

As countries decentralize, a chasm may develop between maintaining tight financial controls versus more autonomy in (departmental) management control. The touchstone of new (decentralized) public management (NPM) includes devolution, decontrol, and a focus upon accountability for results. The intention is that departmental management should focus strongly upon the bottom-line operating results. Yet under the NPM decentralized control environment, departments continue to be subject to treasury administrative controls whenever they seek their newfound autonomy.²⁶

- In Australia, despite having decentralized managerial autonomy, departmental managers are unable to use own source funding, be it from depreciation, asset sales, or accumulated profits, as they deem fit. Departmental managers must obtain Treasury approval for dealing with these transactions. If an Australian government department builds up significant accumulated profits, it may be forced by the Treasury to apply those funds to ordinary operating expenses that ought to be met from the payment for outputs appropriation.
- In Kosovo, financial control is exercised by the Treasury so as to achieve specific fiscal targets. Under the current cash accounting and budgeting regime, the Government of Kosovo's Ministry of Finance and Economics is focused on the cash budget balance. However, as Kosovo moves forward in its development, a gulf may be created between devolution (new public management) rhetoric and the reality of continued firm central treasury financial control. Reorienting internal management controls within the new public management (i.e., financial control versus departmental autonomy) will be an ongoing challenge.

3. Public Sector Auditing

The instruments of fiscal transparency, including medium-term fiscal strategies, annual accounts, budgets, and audits, are utilized in conjunction with other means to render greater accountability. Specifically, accountability rests upon two primary pillars: (i) the role of the legislative body in the approval of policies, budgets, and annual audited reports; and (ii) the role of the audit in aiding the representative bodies to carry out the verification exercise.²⁷

The form of audit varies from one country to another. In some countries, auditors carry out an *a priori* audit. Some are engaged in *ex post* or performance audits. Although practices vary, the primary issue relates to the extent to which transparency and accountability are effective in fulfilling the tasks for which they are designed. This section reviews the nature and form of audit in increasing access to fiscal information and increasing transparency.

3.1 The Framework

The underlying framework for public auditing is derived from the following two organizations:

- *The International Federation of Accountants* (IFAC)²⁸ defines auditing “as a verification or examination of the documents executed by an auditor with the objective of providing him the ability to express an opinion of those documents in such a way as to provide them with greater credibility.”
- *International Organization of Supreme Audit Institutions* (INTOSAI)²⁹ defines “Auditing as an examination of operations, activities, and systems of a specific entity, to verify that they are executed or function in conformity with certain objectives, budgets, rules, and requirements.”

The IFAC and INTOSAI definitions of auditing have overlapping features. However, in brief, auditing is merely a technique in the service of necessary institutional and financial control, but should not be considered as an end unto itself.

3.2 Types of Audits

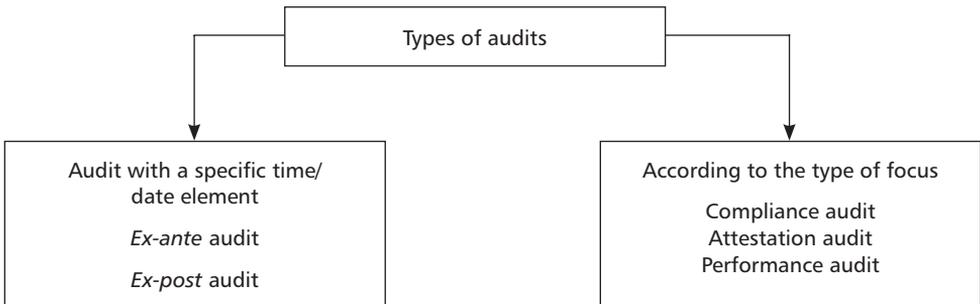
Allen and Tommasi (2001) detail five broad categories of public sector audit (Figure 3), as follows:

- **Ex-ante audit:** examines the transactions for propriety before they are completed. A payment may not be made until the auditor has approved the related voucher after examining the supporting documents. Havens (1999) indicates that centralized *ex-ante* auditing is still practiced by the Supreme Audit Institution (SAI) in many countries. However, over the last decade, such audits are increasingly being viewed as being an element of the management control structure and as such should be the responsibility of the public sector manager rather than the SAI. As a result, *ex-ante* auditing by SAIs has been largely eliminated. Most SAIs focus primarily on the reliability of the measures taken by each public sector organization to avoid improper payments and other transactions.
- **Ex-post audit (financial audit):** examines the transactions after they have occurred. *Ex-post* audit includes regularity audit that contents attestation of financial accountability. This involves examining the financial records, statements, audit of financial systems, and transactions including compliance with applicable statutes and regulations, audit of internal controls, and internal audit functions. The objective of such audits is to determine the reliability of financial data.
- **Compliance audit (regularity audit):** involves checking individual transactions after the fact to ensure that the appropriate authorizations and documentations are present. The focus is on determining the legal propriety of the transactions. The purpose of compliance auditing is to strengthen the systems to prevent irregularities, not just to detect past errors. Havens (1999) points out that few SAIs have sufficient staff resources to examine every transaction for every unit of government. As a result, it is essential that the SAI use available auditing capacity to strengthen the management controls of the public sector organization, such that financial irregularities are minimized.³⁰
- **Attestation audit:** Many supreme audit agencies are required to perform annual audits of the national budget or other government financial reports. The audit report may be required before the legislation can close the accounts on the budget year. An attestation audit is primarily a compliance audit, aimed at detecting irregularities such as overspending or the use of budget resources for activities not authorized by the parliament. The purpose of an attestation audit is to render an opinion as to whether the reader of the statement of the report can be reasonably sure that the information contained in the report is correct.
- **Value for money/performance audit:** A value for money (VFM) audit examines an entire entity, activity, or program to suggest ways that the entity can improve the efficiency of its operations.³¹ In effect, the auditor searches for areas of waste and mismanagement.³² The boundary between value for money and performance audits is not substantial. Where VFM audits focus on efficiency (cost per unit of output), program evaluations focus on outputs (amounts accomplished) or outcomes.

The number and nature of audit functions implies that any SAI must determine what type of audit role is strategically advantageous for it to perform.³³ For a variety of reasons, SAIs do not have the capacity, skills, and time to perform all of the above-mentioned audit functions. Most SAIs rarely perform the most advanced types of program evaluations (or even in many instances, value for money analysis). Because of the potential diversity of tasks that any SAI may undertake, it is essential that careful consideration be given to focusing on the institution's and the public sector's highest priorities.

In most instances, the highest priority of an government's public financial auditing capabilities should be dedicated to maintaining the integrity of the public financial systems in order to minimize corruption. In order to maintain this external audit integrity, SAI's must be independent from the government, have a legal mandate to audit budget organizations, and report their findings directly to the legislature (i.e., parliament). Crucial to the independent oversight is that audit information must be released for general public review and inspection.

Figure 3.
Types of Audits



3.3 Internal Control and Audit³⁴

INTOSAI standards define internal control and audit as: the organization, policies, and procedures used to ensure that government programs achieve their intended risks, that the resources used to deliver these programs are consistent with the stated aims and objections of the organization's concerned, and that the programs are protected from waste, fraud, and mismanagement, and that reliable and timely information is obtained. In brief:

- **Internal controls** include:
 - **Physical controls:** security procedures intended to control assets.
 - **Accounting controls:** procedures by which transactions are required to be recorded in the accounting system.
 - **Process controls:** procedures designed to ensure that actions are taken only with proper authorization.
 - **Procurement controls:** procedures that monitor the procurement cycle to ensure that procurement procedures are implemented appropriately.
 - **Separation of duties:** procedures that ensure that at least two people should be involved in transactions to minimize the risk of improper actions.³⁵
- **Internal audits** check and assess the organization's systems and procedures to minimize errors, fraud, and inefficient procedures. Internal audit is generally carried out by a department(s) within a government entity.

Independence is a necessary condition for any internal audit function. This means that the internal audit department must not be a part of the budget or treasury function of the spending unit, but must report directly to the minister.³⁶

3.4 Reporting Audit Results³⁷

Requirements for the distribution of audit reports is usually specified in the laws concerning supreme audit institutions (and their various implementing rules, authority, and responsibilities). The general rule for distributing audit reports should be to provide copies to those with an interest in the topic and especially those who should act on the findings and recommendations contained in the report. The audited entity and the Ministry of Finance (MoF) should always be provided information on the results of an audit.

In addition, the general public has an interest in the results of audits of public entities and the use of public funds. In many countries, all audit reports completed by a Supreme Audit Institution are made available to the public unless they must be restricted for national security reasons. SAIs may be empowered to order corrective actions of certain kinds when irregularities are found during an audit. However, this authority is usually available only with respect to matters of (ir)regularity. Many SAIs may lack such authority even when substantial irregularities exist. For the most part, auditors are authorized only to report what they have found, and must rely on others to correct the reported problems.

3.5 Auditing and Local Governments

In general a local government's audit report should: (i) analyze the financial position of the local government, including trends, quality of receipts (revenues), and expenditures; (ii) evaluate the performance of the government on various financial management and accounting issues; and (iii) include audit observations on aspects such as irregularities and non-observance of rules and regulations, unnecessary (or wasteful) expenditures, and inefficiency, delays, and non-achievement of objectives with respect to budget implementation.

What exactly is audited when a local government is audited? Is it just the financial statement of the local government (i.e., municipality, urban local body) that is audited? Or are the affiliated entities (i.e., the water utility, etc.) of the local government also audited? Often what is audited at the local government level differs by locality or country. In some countries various off-budget units (i.e., water utility, solid waste management departments) are viewed as separate legal entities incorporated under the relevant commercial law. In this case, the audit function depends almost solely on the decision of the board of directors with no direct state (or local self-government) involvement other than that of an ordinary shareholder participating in the board elections. Even if these off-balance sheet entities are incorporated under commercial law, they still can (and should) be viewed as part of the local government's assets and therefore should be subject to outside audit by a government office.

3.6 Audit Limitations

The function of an independent audit system generally reinforces the trust that the public has with respect to the public sector. During the past decade, efforts have been made to establish comprehensive audit systems in a number of countries. While the creation of audit systems in many countries has been a remarkable achievement, the overall performance of the audit systems in these countries leaves a lot to be desired. For example:

- Audits may not be permitted to review government policies;
- Financial audits may yield limited results;³⁹
- Audit evaluations may be unable to follow the full trail of government expenditures; and
- Transfers to local governments, non-governmental organizations, and the books of contractors that perform many tasks for the government may be beyond the scope of the auditor.³⁹

In many cases, audit continues to be of a conventional accountancy type with little reliance on the performance or investigative audit. Further, the purview of the audit maybe constrained by the enabling country-specific laws. As a result, the nature of country-specific audits may be outdated or ineffectual. In auditing financial statements, an auditor can only provide *reasonable assurance* that the statements are reliable. Neither the auditor nor the reader of the audited report should be under the assumption that such an opinion is a guarantee that there are no material errors in the financial statements.

With respect to local government auditing, several shortcomings with respect to local government audit practices generally emerge.

- The audit appears to be principally oriented towards reviewing transactions rather than performance or systems. Audit observations on individual transactions or programs are useful. However, it may be difficult for local government officials to easily evaluate the nature or severity of the issues being highlighted based on these individual observations alone.
- In general, developing country audit practices do not focus on a systematic review of the effectiveness of the internal control system(s) and its various components within which individual transactions are recorded.
- In some cases an appropriate certification of the financial reports (annual accounts) is not provided. Further, in many cases, the audit report inadequately highlights distortions in the annual account.

Even when the audit report highlights some distortions in local government financial practices, there may be a general lack of responsiveness and actions undertaken to audit observations. Some of these shortcomings can be overcome by building local government and staff capacity, establishing uniform and transparent financial management and accounting (auditing) procedural norms, and standardizing local government financial information systems, thereby enabling more effective internal (and external) auditing.

4. Mechanisms for Improving Information Flows: Directions for Reform

The preceding sections presented a number of fundamental issues that may adversely affect public sector transparency and accountability. The following sections outline some basic policy considerations/ideals for improving transparency and accountability. However, due to various factors, these ideals are often compromised.

4.1 Simplicity of the Accountability Mechanism

Russel-Einhorn (2004) suggests that there are three useful criteria for evaluating transparency and accountability mechanisms relevant to local circumstances in developing countries, including:

1. Degree of visibility of the mechanism in question.
2. The simplicity of the mechanism.
3. The degree to which use of the mechanism can have a direct rather than indirect impact on government policies and programs.

The rationale for these criteria encompasses a number of practical factors, including placing a premium on high-visibility accountability mechanisms in order to cultivate a sense of community empowerment and collective action. In general, governments whose policies are put in question in a very public forum often find it more difficult to obfuscate their intentions.⁴⁰

High costs can significantly retard the utility of any accountability tool. Accountability tools where the costs and legal sophistication are manageable may achieve better results, than those where relatively greater resources and expenditures are required. The third criterion is important given the need for demonstrable civic action.⁴¹ While building enhanced government accountability in developing countries is a long-term process, reform momentum critically depends on the ability to influence policy relatively quickly.

4.2 Reporting Basis Should Be Consistent

The budget is a key management document in the public sector and accountability is based on implementing the budget as approved by the legislature. If the budget is on a cash basis, then the cash method of financial reporting will be the dominant basis on which politicians and budget organizations will work. Financial reporting on a different basis, or accrual basis, risks becoming a technical accounting exercise. As a result, to maximize benefits, countries must fully implement accrual budgeting *and* accounting. The problem with applying accruals only to financial reporting and not to the budget is that the accrual information will not be taken seriously.

In addition, different accrual accounting frameworks may often be applied in preparing budgets and reports. This may cause unnecessary confusion. For example, budgets for the Australian budget sector are prepared on the IMF Government Financial Statistics (GFS) basis.⁴² Financial reports are prepared in accordance with Australian accounting standards. The operating balance measure produced by these two accounting

framework can be substantially different, with non-trivial implications for fiscal policy.⁴³

4.3 No System of Controls Is Foolproof

No system of accounting, budgeting, or managerial (financial) controls can provide an absolute guarantee against the occurrence of inefficiency, abuse, human error, or fraud. Notwithstanding, a well-designed system of internal and external controls and audit functions can give reasonable assurance that significant irregularities will be detected.

- Internal audit, for example, should be integrated into normal operational systems to assist management in assessing risks and developing more cost-effective controls.
- External audit is typically performed by a separate organization. The credibility of external audits requires that the Supreme Audit Institution be independent of the public sector entities being audited and have unfettered access to the required information.

However, no audit can provide absolute assurance of detecting every human or management system error. No audit can provide absolute assurance that every financial irregularity will be detected. An audit can give only reasonable assurance that any material errors will be found and reported.

4.4 Improving Communications Is Essential

According to a number of World Bank and Asian Development Bank surveys, the countries that moved to a well-defined accrual accounting system and a more modern audit and monitoring environment generally cite the need for more and better communications as the single biggest factor that was underestimated during implementation.⁴⁴ Further, close communication with the Supreme Audit Institution (SAI) is cited as being the most important feature in any movement towards improved financial reporting and accountability. The SAI should reinforce the reform process and assist entities in implementation.

Experience also reveals that a substantial communications gap may exist with the media and, by extension, with the general public with respect to reporting of financial (accrual) budgets and financial statements. In particular, the public may have limited understanding of the figures and the underlying concepts. Many countries have combated this lack of financial reporting education by developing “media financial reporting” training sessions.

4.5 Transparency of Rules, Regulations, Laws, and Processes

The lack of transparency in rules, laws, and process in many countries lessens government accountability. Rules dealing with government financial management and accounting are often confusing. Even if an individual exercises some initiative and tries to understand the rules, the documents specifying these rules may not be publicly available. Furthermore, many organizational rules may be changed without public announcements to that effect. In many instances, regulations and laws are written so that only trained lawyers can understand their true impact.

Many laws are often conceptually opaque, thus leaving grounds for different interpretation. One of the ways to increase accountability in opaque regulations and laws is to establish more efficient regulation processes. The establishment of independent audit agencies can be effective in promoting efficiency and limiting opportunities for corruption. These regulatory institutions however, must operate with transparency (hold public meetings), simplicity (rules-based principles), and accountability (election of regulators or term-based regulators).

5. Conclusion

Good governance and effective national (or sub-national) government accountability are the single most important vehicles for establishing a country's economic and social priorities within the scarce resources that are available to government. Good governance (national [sub-national] government accountability) is an essential feature of a framework for economic and financial management including: financial and economic stability, promotion of efficient institutions, and social and economic equity. Public sector accountability may not achieve its potential if not guided by coherent and universal principles: strengthening governance (accountability, transparency, predictability, and participation); reinforcing the foundation of civil society; and engaging in improvements in public expenditure management programs. In addition, programs to increase public sector accountability must carefully consider the country-specific context.

Annex 1

Overview of Cash Basis IPSAS⁴⁵

The purpose of this section is to give a summary review of the mandatory and voluntary reporting requirements under the IPSAS cash basis of accounting, as outlined in the specific international accounting standard.⁴⁶ This section should not be viewed as replacing the cash-based IPSAS standard. However, it summarizes the most relevant points for easier reference and gives additional commentary.

▪ Objective of Cash-basis Reporting Standard

Information about cash receipts, cash payments, and cash balances is necessary for accountability purposes and provides useful input for assessing the ability of the government to generate adequate cash in the future and the likely sources and uses of cash. In making and evaluating decisions about the allocation of cash resources and the sustainability of the government's activities, users of the government's financial statements require an understanding of the timing and certainty of cash receipts and cash payments.

Compliance with the mandatory and encouraged adherence to the voluntary requirements of the cash-based standard will enhance comprehensive and transparent financial reporting of the cash receipts, cash payments, and cash balances of the government. It will also enhance comparability with the government's own financial statements of previous periods and with the financial statements of other entities within the government or across governments that adopt the cash basis of accounting.

The Cash-basis IPSAS is focused on reporting cash balances, movement in those balances over a reporting period, and who controls those balances. The concept of control, especially control over cash, is a fundamental concept that runs throughout the standard and significantly affects how individual budget entity statements are presented (especially important when a Single Treasury Account system is used, as is the case for Kosovo). In addition, the control concept determines which entities are to be consolidated in the whole of government accounts.

▪ Structure of Cash-basis IPSAS

In order for a government to state that its financial statements are in compliance with the IPSAS standard "Financial Reporting under the Cash Basis of Accounting," it must adhere to *all relevant* requirements of the standard illustrated below. The financial reporting under the cash basis of accounting defines the cash basis of accounting, establishes the mandatory general purpose statements and the requirements for the disclosure of information in the financial statements and supporting notes, and deals with a number of specific reporting issues, such as correction of noted errors, consolidated financial statements, foreign currency transactions, restrictions on cash balances, access to borrowings, and other budget entity identification disclosures.

Table A.1
 Tabular Review of Mandatory IPSAS Requirements, with Commentary

PART I, MANDATORY	
Scope of the Requirements	
1.1.4	An entity whose financial statements comply with the requirements of Part 1 of this Standard should disclose that fact. Financial statements should not be described as complying with this Standard unless they comply with <i>all</i> the requirements in Part 1 of the Standard.
1.1.5	This Standard applies to all public sector entities other than Government Business Enterprises.
Presentation and Disclosure Requirements	
Financial Statements	
1.3.4	An entity should prepare and present general purpose financial statements which include the following components: <ul style="list-style-type: none"> (a) a statement of cash receipts and payments which: <ul style="list-style-type: none"> (i) recognizes all cash receipts, cash payments, and cash balances <i>controlled</i> by the entity; and (ii) separately identifies payments made by third parties on behalf of the entity in accordance with paragraph 1.3.24 of this Standard; (b) accounting policies and explanatory notes; and (c) when the entity makes publicly available its approved budget, a comparison of budget and actual amounts either as a separate additional financial statement or as a budget column in the statement of cash receipts and payments in accordance with paragraph 1.9.8 of this Standard.
1.3.5	When an entity elects to disclose information prepared on a different basis from the cash basis of accounting as defined in this Standard or otherwise required by paragraphs 1.3.4(a) or 1.3.4(c), such information should be disclosed in the notes to the financial statements.

Information To Be Presented in Statement of Cash Receipts and Payments	
1.3.12	<p>The statement of cash receipts and payments should present the following amounts for the reporting period:</p> <ul style="list-style-type: none"> (a) total cash receipts of the entity showing separately a sub-classification of total cash receipts using a classification basis appropriate to the entity's operations; (b) total cash payments of the entity showing separately a sub-classification of total cash payments using a classification basis appropriate to the entity's operations; and (c) beginning and closing cash balances of the entity
1.3.13	<p>Total cash receipts and total cash payments, and cash receipts and cash payments for each sub-classification of cash receipt and payment, should be reported on a gross basis, except that cash receipts and payments may be reported on a net basis when:</p> <ul style="list-style-type: none"> (a) they arise from transactions which the entity administers on behalf of other parties and which are recognized in the statement of cash receipts and payments; or (b) they are for items in which the turnover is quick, the amounts are large, and the maturities are short.
1.3.24	<p>Where, during a reporting period, a third party directly settles the obligations of an entity or purchases goods and services for the benefit of the entity, the entity should disclose in separate columns on the face of the statement of cash receipts and payments:</p> <ul style="list-style-type: none"> (a) total payments made by third parties which are part of the economic entity to which the reporting entity belongs, showing separately a sub-classification of the sources and uses of total payments using a classification basis appropriate to the entity's operations; and (b) total payments made by third parties which are not part of the economic entity to which the reporting entity belongs, showing separately a sub-classification of the sources and uses of total payments using a classification basis appropriate to the entity's operation. <p>Such disclosure should only be made when during the reporting period the entity has been formally advised by the third party or the recipient that such payment has been made or has otherwise verified the payment.</p>

Accounting Policies and Explanatory Notes	
Structure of the Notes	
1.3.30	The notes to the financial statements of an entity should: <ul style="list-style-type: none"> (a) present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied for significant transactions and other events; and (b) provide additional information which is not presented on the face of the financial statements but is necessary for a fair presentation of the entity's cash receipts, cash payments, and cash balances.
1.3.31	Notes to the financial statements should be presented in a systematic manner. Each item on the face of the statement of cash receipts and payments and other financial statements should be cross-referenced to any related information in the notes.
Selection and Disclosure of Accounting Policies	
1.3.34	The accounting policies section of the notes to the financial statements should describe each specific accounting policy that is necessary for a proper understanding of the financial statements, including the extent to which the entity has applied any transitional provisions in this Standard.
General Considerations	
Authorization Date	
1.4.5	An entity should disclose the date when the financial statements were authorized for issue and who gave that authorization. If another body has the power to amend the financial statements after issuance, the entity should disclose that fact.

Information about the Entity	
1.4.7	An entity should disclose the following, if not disclosed elsewhere in information published with the financial statements: <ul style="list-style-type: none"> (a) the domicile and legal form of the entity, and the jurisdiction within which it operates; (b) a description of the nature of the entity's operations and principal activities; (c) a reference to the relevant legislation governing the entity's operations, if any; and (d) the name of the controlling entity and the ultimate controlling entity of the economic entity (where applicable, if any).
Restrictions on Cash Balances and Access to Borrowings	
1.4.9	An entity should disclose in the notes to the financial statements together with a commentary, the nature and amount of: <ul style="list-style-type: none"> (a) significant cash balances that are not available for use by the entity; (b) significant cash balances that are subject to external restrictions; and (c) undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.
Consistency of Presentation	
1.4.13	The presentation and classification of items in the financial statements should be retained from one period to the next unless: <ul style="list-style-type: none"> (a) a significant change in the nature of the operations of the entity or a review of its financial statements presentation demonstrates that the change will result in a more appropriate presentation of events or transactions; or (b) a change in presentation is required by a future amendment to this Standard.

Comparative Information

- 1.4.16 Unless a provision of this Standard permits or requires otherwise, comparative information should be disclosed in respect of the previous period for all numerical information required by this Standard to be disclosed in the financial statements, except in respect of the financial statements for the reporting period to which this Standard is first applied. Comparative information should be included in narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.
- 1.4.19 When the presentation or classification of items required to be disclosed in the financial statements is amended, comparative amounts should be reclassified, unless it is impracticable to do so, to ensure comparability with the current period, and the nature, amount of, and reason for any reclassification should be disclosed. When it is impracticable to reclassify comparative amounts, an entity should disclose the reason for not reclassifying and the nature of the changes that would have been made if amounts were reclassified.

Identification of Financial Statements

- 1.4.21 The financial statements should be clearly identified and distinguished from other information in the same published document.
- 1.4.23 Each component of the financial statements should be clearly identified. In addition, the following information should be prominently displayed and repeated when it is necessary for a proper understanding of the information presented:
- (a) the name of the reporting entity or other means of identification;
 - (b) whether the financial statements cover the individual entity or the economic entity;
 - (c) the reporting date or the period covered by the financial statements, whichever is appropriate to the related component of the financial statements;
 - (d) the reporting currency; and
 - (e) the level of precision used in the presentation of figures in the financial statements.

Correction of Errors	
1.5.1	When an error arises in relation to a cash balance reported in the financial statements, the amount of the error that relates to prior periods should be reported by adjusting the cash at the beginning of the period. Comparative information should be restated, unless it is impracticable to do so.
1.5.2	An entity should disclose in the notes to the financial statements the following: <ul style="list-style-type: none"> (a) the nature of the error; (b) the amount of the correction; and (c) the fact that comparative information has been restated or that it is impracticable to do so.
Consolidated Financial Statements	
1.6.5	A controlling entity, other than a controlling entity identified in paragraphs 1.6.7 and 1.6.8, should issue consolidated financial statements which consolidates all controlled entities, foreign and domestic, other than those referred to in paragraph 1.6.6.
1.6.6	A controlled entity should be excluded from consolidation when it operates under severe external long-term restrictions that prevent the controlling entity from benefiting from its activities.
1.6.7	A controlling entity that is a wholly owned controlled entity need not present consolidated financial statements provided users of such financial statements are unlikely to exist or their information needs are met by the controlling entity's consolidated financial statements.
1.6.8	A controlling entity that is virtually wholly owned need not present consolidated financial statements provided the controlling entity obtains the approval of the owners of the minority interest.

Consolidation Procedures

1.6.16 The following consolidation procedures apply:

- (a) cash balances and cash transactions between entities within the economic entity should be eliminated in full;
- (b) when the financial statements used in a consolidation are drawn up to different reporting dates, adjustments should be made for the effects of significant cash transactions that have occurred between those dates and the date of the controlling entity's financial statements. *In any case, the difference between the reporting dates should be no more than three months;* and
- (c) consolidated financial statements should be prepared using uniform accounting policies for like cash transactions. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

Consolidation Disclosures

1.6.20 The following disclosures should be made in consolidated financial statements:

- (a) listing of significant controlled entities including the name, the jurisdiction in which the controlled entity operates (when it is different from that of the controlling entity); and
- (b) the reasons for not consolidating a controlled entity.

Treatment of Foreign Currency Cash Receipts, Payments, and Balances

1.7.2 Cash receipts and payments arising from transactions in a foreign currency should be recorded in an entity's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency *at the date of the receipts and payments.*

1.7.3 Cash balances held in a foreign currency should be reported using the *closing rate.*

1.7.4 The cash receipts and cash payments of a foreign-controlled entity should be translated at the exchange rates between the reporting currency and the foreign currency *at the dates of the receipts and payments.*

1.7.5 An entity should disclose the amount of exchange differences included as reconciling items between opening and closing cash balances for the period.

1.7.6 When the reporting currency is different from the currency of the country in which the entity is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

Presentation of Budget Information in Financial Statements	
Presentation of a Comparison of Budget and Actual Amounts	
1.9.8	Subject to the requirements of paragraph 1.9.17, an entity that makes publicly available its approved budget(s) shall present a comparison of the budget amounts for which it is held publicly accountable and actual amounts either as a separate additional financial statement or as additional budget columns in the statement of cash receipts and payments currently presented in accordance with this Standard. The comparison of budget and actual amounts shall present separately for each level of legislative oversight: <ul style="list-style-type: none"> (a) The original and final budget amounts; (b) The actual amounts on a comparable basis; and (c) By way of note disclosure, an explanation of material differences between the budget for which the entity is held publicly accountable and actual amounts, unless such explanation is included in other public documents issued in conjunction with the financial statements, and a cross-reference to those documents is made in the notes.
Presentation	
1.9.17	An entity shall present a comparison of budget and actual amounts as additional budget columns in the statement of cash receipts and payments only where the financial statements and the budget are prepared on a comparable basis.
Changes from Original to Final Budget	
1.9.23	An entity shall present an explanation of whether changes between the original and final budget are a consequence of reallocations within the budget, or of other factors, either: <ul style="list-style-type: none"> (a) by way of note disclosure in the financial statements; or (b) in a report issued before, at the same time as, or in conjunction with the financial statements, and shall include a cross-reference to the report in the notes to the financial statements.

Comparable Basis	
1.9.25	All comparisons of budget and actual amounts shall be presented on a comparable basis to the budget.
Note Disclosures of Budgetary Basis, Period, and Scope	
1.9.33	An entity shall explain in notes to the financial statements the budgetary basis and classification basis adopted in the approved budget.
1.9.37	An entity shall disclose in notes to the financial statements the period of the approved budget.
1.9.3	An entity shall identify in notes to the financial statements the entities included in the approved budget.
Reconciliation of Actual Amounts on a Comparable Basis and Actual Amounts in the Financial Statements	
1.9.41	The actual amounts presented on a comparable basis to the budget in accordance with paragraph 1.9.25 shall, where the financial statements and the budget are not prepared on a comparable basis, be reconciled to total cash receipts and total cash payments, identifying separately any basis, timing, and entity differences. The reconciliation shall be disclosed on the face of the statement of comparison of budget and actual amounts or in the notes to the financial statements.
1.9.45	The disclosure of comparative information in respect of the previous period in accordance with the requirements of this Standard is not required.

Annex 2

Fiduciary Risks and Potential Safeguards

Table A.2
Fiduciary Risks and Potential Safeguards

BUDGET EXECUTION				
Process	Weaknesses	Likely Impact	Potential Safeguards	Long-term Solutions
Expenditure with year is controlled	In-year financial reporting is late/ or inaccurate	Mismanagement risks; failure to meet performance objectives	Strengthen government accounting and reporting	Develop and apply appropriate accounting procedures
	Failure to adhere to budget discipline through overspending or viring of funds	Unfunded liabilities which have to be met from the next year's budget or by reducing service delivery; failure to meet policy objectives	Control and monitoring of commitments and arrears; centralize control over payments	Strengthen internal audit functions; monitor and enforce compliance with financial instructions
	Release of funds from treasury to spending units is unpredictable	Adverse impact on the availability and quality of public services; credibility of the budget is undermined	Modify disbursements to help smooth out uneven government cash flow	Improve/ introduce cash flow forecasting
	Idle cash balances	Reduction in resources available for service delivery	Monitor cash balances and reduce rate of disbursement if funds are not being used	Rationalize bank account structure

Process	Weaknesses	Likely Impact	Potential Safeguards	Long-term Solutions
Reporting of expenditure is timely and accurate	Failure to reconcile fiscal and bank records	Risk of overspending being uncontrolled leading to unplanned and arbitrary cuts in public expenditures	Introduce improved manual reporting procedures	Automate government accounting systems
	Final audited accounts late	Uncertainty whether or not funds have been used effectively	External assistance to help prepare government accounts to clear backlogs in key budget departments	Monitor and enforce compliance with financial instructions
	Basic accounting records are not accurately maintained	Late or non-existent in-year financial reporting; uncertainty whether funds have been used for intended purposes; increased risk that mismanagement and fraud remain undetected	External assistance to help prepare government accounts to clear backlogs in key budget departments	Develop and apply accounting procedures
	Expenditure reporting does not provide information about outputs/outcomes	Problems assessing impact of expenditures and targeting future expenditures on sectoral programs	Expenditure tracking surveys	Revise account code structures to support programmatic approach to budgeting and reporting

INDEPENDENT OVERSIGHT				
Process	Weaknesses	Likely Impact	Potential Safeguards	Long-term Solutions
Effective Independent Scrutiny of Government Expenditure	Supreme audit institution is either not resourced or not empowered to conduct effective scrutiny	Government not held to account for its stewardship of public funds; increased risks of mismanagement and fraud	Increased independent auditing of government spending	Strengthening capacity and independence of Supreme Audit Institutions (SAI)

Source: Department for International Development (DFID). 2002. "Managing Fiduciary Risk When Providing Direct Budget Support." London: DFID.

Annex 3

OECD Best Practices for Budget Transparency: Integrity, Control, and Accountability⁴⁷

Accounting Policies

- A summary of relevant account polices should accompany all reports. These should describe the basis of accounting applied (e.g., cash, accrual) in preparing the reports and disclose any deviations from generally accepted accounting practices.
- The same accounting practices should be used for all fiscal reports.
- If a change in accounting is required, then the nature of the change and the reasons for the change should be fully disclosed.
- Information for previous reporting period should be adjusted, as practicable, to allow comparisons to be made between reporting periods.

Systems and Responsibilities

- A dynamic system or internal financial controls, including internal audit, should be in place to assure the integrity provided in the reports.
- Each report should contain a statement of responsibility by the Finance Minister and the Senior Official responsible for producing the report.
- The Minister certifies that all government decisions with a fiscal impact have been included in the report.
- The Senior Official certifies that the Finance Minister has used his/her best professional judgment in producing the report.

Audit

- The year-end report should be audited by the Supreme Audit Institution (SAI), in accordance with generally accepted auditing practices.
- Audit reports prepared by the SAI should be scrutinized by the Parliament.

Public and Parliamentary Scrutiny

- Parliament should have the opportunity and the resources to examine effectively any fiscal report that it deems necessary.
- The Finance Ministry should actively promote an understanding of the process by individual citizens and non-governmental organizations.

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Notes

- ¹ The definition of accrual basis accounting according to International Public Sector Accounting Standards (IPSAS) is: *A basis of accounting under which transactions and other events are recognized when they occur (and not only when cash or its equivalent is paid). Therefore, the transactions and events are recorded in the accounting record and recognized in the financial statements of the periods to which they relate. The elements recognized under accrual accounting are assets, liabilities, net assets/equity, revenue, and expenses.*
- ² Only the first three objectives are met by cash-based government accounting systems.
- ³ See International Federation of Accountants (IFAC), *Financial Reporting by National Governments*, March 1991.
- ⁴ The International Federation of Accountants issues accounting standards for the public sector. These standards are referred to as International Public Sector Accounting Standards (IPSAS).
- ⁵ The Chart of Accounts must be designed in a collaborative manner between the budget and accounting departments.
- ⁶ A chart of accounts is a listing of all accounts in the general ledger, each account accompanied by a specific reference number. To establish a chart of account, one needs to define the various accounts to be used by the local government. Each account should have a number to identify it. For small local self-governments three (3) digit level account numbers may suffice as an account identifier. With more digits, new accounts may be added while maintaining the logical order.
- ⁷ See Hogye, Mihaly and Charles McFerren. 2002. "Local Government Budgeting: The CEE Experience." In: Mihaly Hogye (ed.). *Local Government Budgeting*. Budapest: Open Society Institute. p. 51.
- ⁸ Regardless of the accounting system used (accrual or cash basis), it is essential that local government financial accounts be timely and accurate.

- ⁹ For a more detailed discussion, see Michael Schaeffer. 2000. "Municipal Budgeting Toolkit." World Bank.
- ¹⁰ See Annex 1: Overview of Cash-basis IPSAS.
- ¹¹ Cash-basis accounting has serious limitations because it does not adequately record liabilities, either to provide future services or in recognition of services or goods received for which the bill has not been paid.
- ¹² All accounting systems must include such cash records, but cash journals and ledgers by themselves do not constitute accounting or budgeting systems. This is because cash records do not indicate the time period to which a given transaction relates. The cash from receipt of a prior year receivable cannot be distinguished from receipt of revenues due for the first time, nor can disbursement on an expenditure account incurred this year be distinguished from a liability held over unpaid from the prior year.
- ¹³ Accrued means appropriately accounted for assets and liabilities. For example, in cash accounting, if there is an unpaid invoice at the end of an accounting period in which a credit transaction occurred, and no accrual is made, the transaction is not recognized for accounting purposes until the invoiced amount is paid, in a subsequent period to that when the transaction event occurred.
- ¹⁴ Sources of quotation: For Croatia: Kraft, Evan and Tihomir Strucka. 2002. *Fiscal Consolidation, External Competitiveness and Monetary Policy: A Reply to the WIIW*. May. Zagreb: Croatian National Bank. pg. 1.; For United States: US Government. 2002. 2001 *Financial Report of the United States Government*. Washington, D.C., p. 1.
- ¹⁵ Accrual reporting recognizes expenses incurred during the year, even if the expenses were not paid for, and links the annual financial statement directly with changes in assets and liabilities in the local government's financial position.
- ¹⁶ Obviously, there are relatively few revenues that can be accrued in the technical sense—property taxes, some franchise taxes, and fiscal aid. Revenues not susceptible to accrual are in practice booked as cash received. It is important that accurate distinction be made between current year, prior year, and future year transactions.
- ¹⁷ There are two means of establishing reserve accounts. One is to establish these accounts at the beginning of the fiscal year, when the budget anticipations and appropriations are entered as controls for the budgetary accounts. The other is to establish or adjust reserves during, at the end, or after the close of the fiscal year.
- ¹⁸ Accrual accounting remains a distant goal for many national, state, and local governments.
- ¹⁹ The OECD countries that appropriate resources on an accrual basis include Australia, Finland, Iceland, and New Zealand.
- ²⁰ Matheson, Alex. 2002. "Better Public Sector Governance: The Rationale for Budgeting and Accounting Reform in Western Nations." *OECD Journal on Budgeting* Vol 2(1), December. pp. 44–45.
- ²¹ See Haven, Harry. 1999. "Management Controls, Audit and Evaluation." In: Shiavo-Caompo and Daniel Tommasi. *Managing Government Expenditure*. Manila: ADB.

- ²² European Court of Auditors. 1998. *European Implementing Guidelines for the INTOSAI Auditing Standards*.
- ²³ Conversely, where public integrity (or fiscal discipline) is a major concern, then management control systems that allow discretion without sufficient accountability can also be problematic.
- ²⁴ See Russell-Einhorn, Malcolm. 2004. "Creating and Implementing a Local Transparency Initiative" *Local Government Brief*: p. 24.
- ²⁵ In this case, impact and consequence can be used interchangeably.
- ²⁶ It is far too simplistic to attribute the problem to a general unwillingness on the part of government treasuries to relinquish control. The real problem is that there are fundamental limitations upon the application of a business template to tax-financed government departments.
- ²⁷ Premchand, A. 2001. "Fiscal Transparency and Accountability: Idea and Reality" Paper prepared for the workshop on Financial Management and Accountability, Rome. p. 10.
- ²⁸ IFAC is an organization of national professional accountancy organizations. IFAC issues international standards and guidance in six areas: auditing and related services, education, ethics, financial and management accounting, information technology, and public sector accounting. It has also issued an international code of ethics.
- ²⁹ INTOSAI is the professional organization of 185 Supreme Audit Institutions. INTOSAI has adopted "Guidelines on Auditing Precepts," the so-called "Lima Declaration," which provides institutional principles for SAIs. These principles address *inter alia*: the importance of audit to sound management of public funds; the audit objectives of legality, economy, efficiency, and effectiveness of financial management; and the requirement for independence of the SAI and staff.
- ³⁰ By using strategic audits, the SAI can identify and remedy internal control weaknesses.
- ³¹ Some SAIs have gone beyond the traditional performance (value for money) audit focus.
- ³² For a more thorough review please see Haven, Harry. 1999. "Management Controls, Audit and Evaluation." In: Shiavo-Caompo, S. and Daniel Tommasi. *Managing Government Expenditure*. Manila: ADB.
- ³³ See Annex 2: Fiduciary Risks and Potential Safeguards for improved understanding with respect to how financial reporting and auditing systems can be improved.
- ³⁴ Shiavo-Caompo and Tommasi. Op. cit.
- ³⁵ Separation of duties is an essential element in almost every financial control system.
- ³⁶ The internal auditor should not be involved in the internal control process that he is required to assess.
- ³⁷ This section is largely derived from Haven, Harry. Op. cit.
- ³⁸ Auditors can only audit that which they can observe. If the auditor is allowed to review only limited entity records, the audit itself may be rendered meaningless.
- ³⁹ *Ibid.* p. 14

- ⁴⁰ See Annex 3: OECD Best Practices for Budget Transparency: Integrity, Control, and Accountability for list of best practice measures.
- ⁴¹ Ibid. p. 35.
- ⁴² The IMF Government Finance Statistics (GFS) is a specialized system of public sector financial reporting designed to support public sector analysis. The IMF designed GFS so that government financial information could be compared across countries.
- ⁴³ Robinson, Marc. 2001. "The Treatment of Revaluations in Accrual-Based Government Accounts." *Journal of Accounting, Accountability, and Performance*. Vol. 7(2)
- ⁴⁴ OECD. 2002 *Accrual Accounting and Budgeting: Key Issues and Recent Developments*. Paris: OECD.
- ⁴⁵ Please see World Bank. 2007. "Kosovo: Preparation of Accounting Manual for KCB." Prepared by PDP Australian Consultancy. Volumes I, II, II. This annexure represents an abridged version of the information presented in this very detailed manual.
- ⁴⁶ Based on the International Public Sector Accounting Standard, "*Financial Reporting Under the Cash Basis of Accounting*," issued January 2003 and updated 2006.
- ⁴⁷ OECD. 2001.

Making Deals:
The Relationship between the
Public and Private Sectors

Gábor Péteri

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Abstract

One of the most obvious areas of corruption is where national and local governments directly interact with businesses. Within the expanding market environment public actors meet the private sector through the promotion of economic development and by purchasing goods and services. Within the overall framework of accountability, both grand and petty corruption can be controlled by improvement of the overall regulatory framework (the “long route”) and by increasing the direct influence of service users (“short route”).

In local economic development the risk of corruption is higher when the procedure for getting various permits, mostly for starting businesses, is longer. Governments also provide support for businesses; however, the direct intervention to market mechanisms is going through a transformation. Indirect means of economic development have proved to be more efficient and at the same time they lower the opportunities for corruption.

Public entities purchase goods and services in various forms: buying supplies and equipment, contracting for public service provision under simple arrangements, or through more complex models, like concessions or build-operate-transfer schemes. The risk of corruption is higher with large, unique projects. Lessons on the various techniques of service provision within New Public Management schemes are that anti-corruption policies should focus on the early, planning, and project-design stages of tendering. This chapter summarizes how various combined techniques and actions will enhance the general accountability in public and private sector cooperation in sector cooperation.

1. Introduction

One of the most obvious areas of corruption is where governments meet businesses directly. Both national and local governments manage public functions in a market environment that can offer opportunities for fraudulent actions. For finding the systemic causes of corruption in this area, first the basic characteristics of this relationship have to be identified.

There are two typical areas, where public actors directly cooperate with the private sector.

1. Governments are involved in *economic development*. Despite the reduced direct influence of national and local budgets on privatized companies, governments remain responsible for economic development. In transition countries where the legacy of the command economy still prevails, mayors, councilors, and ministers are usually interested in promoting inward investment: they support small- and medium-size enterprises that are intended to improve local employment.
2. Secondly and more importantly, governments cooperate with the private sector by acquiring goods and services and by ordering public services. Governments *purchase goods and services* from the private sector directly. In general, public procurement rules apply for buying basic products, but some services (e.g., in some countries, financial services) are not the subjects of these regulations. More complex forms of contracts or partnership agreements might be also left out from the standard public procurement procedures, especially when government-owned business entities are involved in service provision.

Since the 1980s, *contracting out* practices and various forms of *public-private partnership* (PPP) have been used widely in Europe. The economic rationale behind the development of New Public Management techniques was the utilization of market incentives and private capital for public benefit. Alternative service delivery arrangements of various kinds aimed at improving service efficiency and access to public services. Beyond the sophisticated schemes in communal, utility, infrastructure, and human services, specific forms of public private partnerships have been designed in urban development as well. These complicated methods are used extensively by the public sector, and as a result the need for fiscal transparency is greater than before.

2. Routes of Accountability

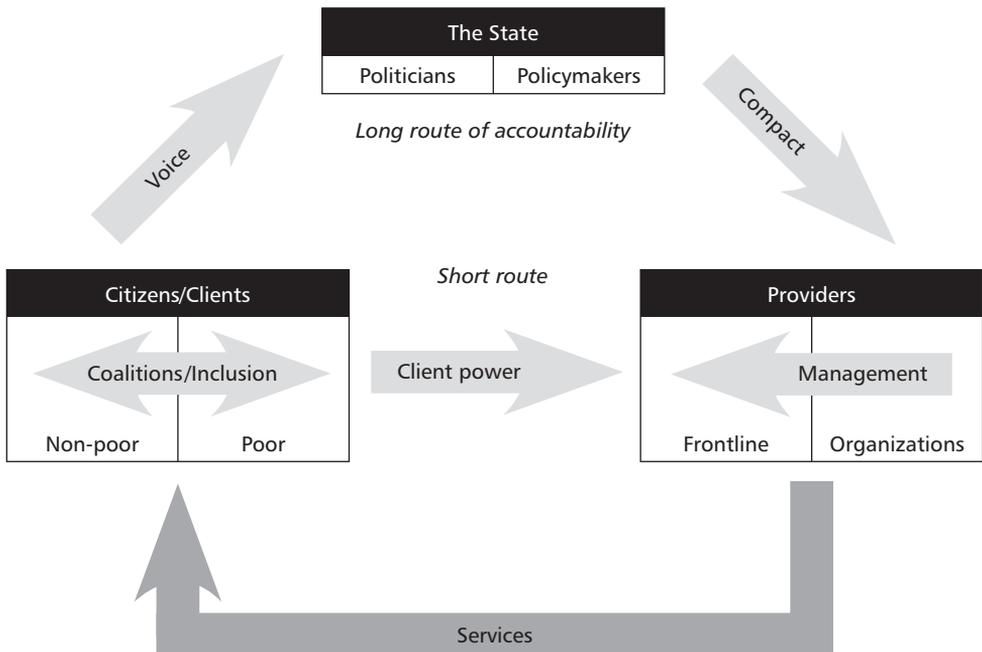
All these forms of cooperation between public and private actors have been significantly transformed during the past two decades. From a fiscal transparency point of view, there

are two types of challenges: how to deal with *grand corruption* and what to do with petty bribery. Grand corruption originates from a shortfall in government policymaking and in the priority-setting process. As the demand for public services is ever increasing, the basic question is, whether the planned project or service is really needed or not.

Both politicians and private contractors are interested in large capital investment programs, highly visible improvements in service provision. But if these projects go beyond the means of the government, then they create excess or unused capacities and consequently may cause financial losses. *Petty corruption* might occur throughout the entire contracting process and it is about the everyday meaning of the terms bribery and corruption.

Risks of these two types of losses can be minimized by better understanding the relationship between the various actors involved in these service delivery arrangements and by creating strong control mechanisms. There are three basic actors in service provision: the state, the clients as service beneficiaries, and the service organizations (Figure 1).

Figure 1.
Actors and Routes of Accountability in Service Provision



Source: World Development Report 2004.

Starting with the government as a key actor within this framework of service provision, there are two critical lines of relationships from an accountability perspective. Firstly, national and local governments are accountable towards citizens, as voters and constituents. Citizens are able to control public actors through various political mechanisms and by expressing their opinion in other ways. Through accountable governments, they might influence the relationship between the governments and the service organizations. This “*long route of accountability*” is completed by the compact between local governments and their service providers.

The compact includes not only the specific contract with the service organization, but the regulatory system as well. Under the New Public Management model the public sector’s role has been transformed: bearing responsibility for service provision does not necessarily mean that public entities have to produce these services themselves. The split between the client government and the contractor created an environment with new roles and responsibilities. The separation of these two functions increases the need for transparency and for new accountability mechanisms. (This will be discussed later.)

Within this triangle the relationship between the service beneficiaries and the service producers also has been transformed. Parallel to the extended use of market-based financing mechanisms—e.g., user charges—the customers became more important actors in service provision. The “*short route of accountability*” between the client and the service provider creates new opportunities for direct control and transparency. Customers’ diverse demands have to be met by those service organizations that earlier served only the average, typical users. A higher dependence on the clients’ payment raised the need for better information flow. From a transparency point of view, the direct relationship between the service organization and customers created new opportunities for corruption.

In this complex relationship of public and private actors the goal of fiscal transparency remained the same: decrease monopoly power, control the discretionary power of the authorities, and improve the accountability mechanisms. All these institutions and procedures have to be adjusted to the local culture and ethics of a given country and a specific municipality.

3. Economic Development

Businesses of various types—private entrepreneurs, small-size enterprises, large companies—meet public authorities for various reasons. There are legal, administrative, and financial connections toward local administration and national government agencies. These contacts offer various options for corruption and bribes. According to business surveys, corruption frequently happens with entrepreneurs, who consider this additional payment as a way to “oil the machinery” of the administration (Table 1).

Table 1.
 “Oiling the Machine”: Additional Payments in Transition Countries [Percent]

How Frequently Is the Following Statement True?	Always	Mostly	Frequently	Sometimes	Seldom	Never
Firms in my line of business usually know in advance how much the “additional payment” is.	10.0	24.0	13.8	22.7	16.2	13.3
If a firm makes an “additional payment,” the service is delivered as agreed.	21.7	39.6	14.9	14.7	6.0	3.1

Source: <http://info.worldbank.org/governance/beeps/>.

Bribes are paid frequently and for a number of reasons. Most of the unofficial payments are made for obtaining licenses and business permits. Tax collectors and customs officers also benefit significantly from these payments. Government contracts are also among the significant illegal expenditure items for businesses (Table 2).

Table 2.
 Purposes of Unofficial Payments in Transition Countries

Of the Total Unofficial Payments per Annum, What Percentage Would Be Spent for the Following Purpose?	Respondents Who Pay More Than 0–10 Percent ¹
To get licenses and permits	49.2%
To deal with taxes and tax collection	55.2%
To gain government contracts	68.5%
To deal with customs and imports	69.2%
To get connection to public services	76.3%
To deal with the courts	78.6%
To deal with health/fire inspectors	81.1%
Other important unofficial payments	92.9%
To influence the content of new laws, decrees, and regulations	93.3%

Source: <http://info.worldbank.org/governance/beeps/>.

The largest share of unofficial payments (bribes) is made to obtain various licenses, typically for starting businesses. The risk of corruption is higher, when the *procedure for getting these permits* is longer. Table 3 illustrates that in OECD countries various govern-

ment licenses are coordinated (i.e., one-stop shopping), so the number of steps to be taken by the businesses are only six, unlike, for example, in poor Sub-Saharan African countries, where it is almost double. Consequently, the time required for starting a new business is much longer, three to four times more, than in leading OECD countries (the longest in Latin America).

Table 3.
Starting a Business

Regions	Procedures [Number]	Duration [Days]
OECD countries	6.2	16.6
South Asia	7.9	32.5
East Asia & Pacific	8.2	46.3
Europe & Central Asia	9.4	32
Latin America & Caribbean	10.2	73.3
Middle East & North Africa	10.3	40.9
Sub-Saharan Africa	11.1	61.8

Source: <http://www.doingbusiness.org>.

The more discretion that is given to authorities, the higher the chances of corruption. Recently, government reforms promote the establishment of one-stop-shops for dealing with businesses as customers. One-stop-shops are primarily directed at making administrative procedures more efficient by coordinating back office activities and providing one access point. However, this internal reorganization of the administration has positive side effects, in that one-stop-shops decrease the opportunity for personal meetings between bureaucrats and applicants, and thereby reduce the opportunity for corruption. Even in countries like Kazakhstan, which is ranked high on the pay of unofficial payments, this was one of the aims of introducing one-stop-shops in city administration (Serban 2006).

3.1 Changing Techniques of LED

The methods and focus of local economic development are also going through a gradual change. Traditional means of the public sector for promoting economic development were primarily the provision of direct benefits to investors. They are specific tax exemptions, tax breaks, government subsidies, provision of land, etc. These instruments proved to be least efficient from an economic point of view, as they distorted the general

economic conditions and created wrong incentives for businesses. As they were about specific support to selected companies and entrepreneurs, they tended to increase the risks of corruption.

However, the current emphasis with respect to economic development is on improving the overall conditions of economic development and establishing an open relationship with all businesses. When all economic actors enjoy the benefits of infrastructure services, only then will the local economy develop. In addition, this shift in government policies towards businesses results in greater transparency.

The main objectives of economic development policies are as follows:

- a) *Local governments should play an integrative role in local business development.* Working in a market environment, municipalities have to harmonize the interest of the business community, the goals of non-governmental and civic organizations, and the general public. Local businesses should be supported through indirect means, by establishing better infrastructure, high quality education, good living conditions, and effective city marketing.
- b) *Local governments' confidence towards local businesses and entrepreneurs should be achieved.* Small- and medium-size enterprises are important actors in the locality as service providers, employers, and tax payers, and they have significant influence on public opinion. Local governments, with their administrative functions, public services, and budgets, might have an impact on local businesses. Techniques and methods of this strategic partnership are crucial for establishing a business friendly environment.
- c) *Public and private functions should be separated.* Local government is a public entity, so it must not be involved directly in profit-making activities. Often lacking sufficient public revenues for funding public services, local governments are attempting to launch profit-making activities. However, public bodies are not risk-taking entities; they usually have no decision-making and management capacity required for running profit-making businesses.

These policy objectives cannot be implemented without inputs from the private sector. As a result, opportunities for corruption will be lower, but only when governments set the general conditions and regulate the rules for connecting to businesses. Generally used methods of incorporating private resources for public sector development are the impact fee and the special assessment or betterment tax (Bland 1989).

1. An *impact fee* is paid by the users of urban infrastructure and public services. The economic rationale behind the impact fee is that capital improvements are needed for servicing additional users. The collection of these revenues should be accumulated in separate funds, ensuring their targeted use.

2. A *special assessment* on property, betterment tax, or a planning gain supplement is aimed to collect revenues from beneficiaries of infrastructure development, changes in urban plan or zoning.

In countries with underdeveloped property taxation and urban planning systems, impact fees are more widely used. They are paid in return for getting building permits or special business licenses. They are in the form of “voluntary contributions” paid by businesses and they often are negotiated between governments and the companies. If these payments are designed in a non-transparent way and the administration enjoys high discretion in levying or renegotiating the impact fees, then there are greater risks for corruption.

In summary, economic development is an important task of national and local governments. However, the rules of supporting businesses are changing. The former techniques, which directly intervened to market mechanisms, have been transformed. Indirect means of economic development have proved to be more efficient and at the same time they lower the opportunities for corruption.

4. Procurement, Contracting Out, and Public-private Partnerships

The other area of private sector involvement in public service production has several forms. Governments and public entities purchase goods and services of various types, ranging from office supplies to military equipment. In this section public procurement will be discussed together with other forms of obtaining public services from the private sector, as the actors and the procedures are similar.

Contracts for public service provision are often called alternative service delivery arrangements. They might vary from simple contracting out practices to more complex models, like concessions or build-operate-transfer schemes. The main reasons for using the private entities are various. Generally, these types of service arrangements are developed on the grounds of New Public Management. Within this framework:

- Private sector incentives are targeted to ensure more efficient use of the available resources in the public sector.
- A lack of resources and budget restrictions also urge the governments to involve private funds in the capital-intensive public services; consequently, the use of private service organizations is sector specific.
- Labor intensive services (e.g., cleaning, park maintenance) are typically contracted out, while in water management, energy provision, and municipal solid waste collection and deposition, where huge capital investments are needed, the more sophisticated PPP (public-private partnership) methods are used.

This model of public service provision is a lucrative business for the *private* sector. It provides stable revenue flow either directly from public funds, or through user charges. Service organizations will be in a monopolistic position for the duration of the contract. All these advantages of working with governments may increase the risk of corruption.

On the *government's* side, cooperation with the private sector is not always easily justified. Beyond the fiscal advantages of private production of services, there are several limitations to working with the private sector. Elected politicians working under fiscal pressure urge improvements in public services by using private funds. The danger is that governments can be captured by private sector contracts, as they enjoy short-term gains, but might suffer long-term losses. Also, politicians might be biased towards new large investments, deferring maintenance and rehabilitation of existing facilities and equipment. The public sector might be caught by a signed contract, when the tasks or the service performance have to be modified. Long-term contracts risk optimistic projections on the level of future inflation or on the estimated discount rates as well.

An accidental consequence of private sector involvement in public service provision is corruption. According to the World Bank estimates, 20 to 40 percent of water sector finances are lost to dishonest and corrupt practices.² But corruption does not happen only between the public and private actors.³ It might occur also *within the public sector*, when permits are issued, the locations of water facilities are selected, and accusations about pollution are silenced. In some countries with centralized communal services provision, utility company management positions are part of the political spoil system.

So contracting out practices and public-private partnership schemes are exposed to various types of corruption. It is not always an exchange of cash, but other social advantages (which can be later transformed to financial benefits). Active and passive forms of corruption happen in the public sector, both on a large scale and as petty but frequent corruption. Prevention of frauds and bribes requires better understanding of these forms of service delivery and the procedures of contract award.

4.1 Alternative Service Delivery Arrangements

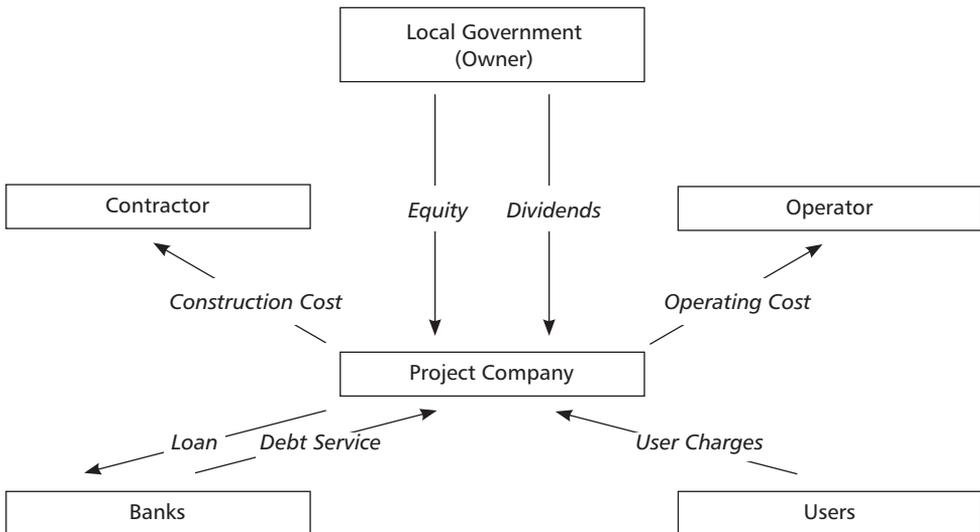
Cooperation between the public sector and private entities takes various forms. Starting with the simplest one, *contracting out* happens when a public service is implemented by a non-state actor. Depending on the characteristics of the service, either business entities or non-profit organizations can be contracted usually for medium or longer periods. In more complicated cases not only the operation and management tasks are contracted out, but capital investments are also part of the agreement (see examples below). That is, private investors make improvements in the service conditions and they

are compensated by the revenue flow from the client or through the charges collected directly from the users.

During the past two decades “build-operate-transfer” (BOT) schemes have been developed in various forms, transferring back to government the assets after an agreed period. These BOT and leasing agreements in utility, communal, and human services were further developed as *public-private partnership* schemes. PPPs involve various actors and they are usually used for more complex forms of cooperation with the private sector.

The classic PPP model is organized around a project company with diverse ownership forms—but primarily initiated by the government or a public agency. As capital investments are also subjects of the partnership, banks and construction companies are involved in the PPP schemes. The other actors are the operator of the facility and obviously the users themselves. Some of the actors presented in Figure 2 might be the same in specific deals (e.g., the contractor and the operator) or these schemes could be further refined (e.g., there are several sources of financing, not just the banks).

Figure 2.
Actors and Financial Flow in PPP Schemes



The introduction of public-private partnership schemes of various types require *legal* conditions. First of all, the regulations should authorize the client government to provide services of general public interest by non-state actors. For establishing a market for these contracted services, they have to be made compulsory (e.g., no other methods of waste management are allowed). As the users are the primary sources of financing,

the level of user charges and methods of revenue administration have to be legislated. As there are public contracts with the private sector, regulations on procurement and contracting should be known as well. All these tasks require improved administrative and *management capacity* at the client governments.

These complicated forms of service delivery offer various opportunities for corruption. Not only the direct relationship with the private sector during the implementation and operation, but at the project planning and design stage, too. Simpler forms of contracting out, for example, with NGOs, have some risks on the government's side, when selective partnerships and individual deals are made with politically supported organizations, which is also a form of corruption.

However, large projects are more open to corruption for several reasons (see Cavil and Sohail 2007):

1. Large and unique projects inflate the claims and make comparison of offers more difficult.
2. Complex projects increase the number of contractual links, number of phases of project implementation, and hide the responsibilities. All of these factors lead to a higher risks of bribes.
3. In large-scale projects, where contactors from various industries are involved, several professional self-regulatory mechanisms and rules have to be followed, which makes their application harder.

So in the case of alternative service delivery arrangements, the most critical components of the contracting process have to be designed in a way that minimizes the corruption risks.

4.2 Stages of Tendering and Contracting

Large-scale infrastructure projects, like in water provision, sanitation, or municipal solid waste management can be divided into several steps (USAID 2006; Shordt et al. 2006). From a transparency point of view, six stages of tendering and contracting were identified below. They are adaptable to simple public procurement actions as well. Governments and contractors, going through these critical steps, might limit corruption risks, if they are aware of these factors.

4.2.1 Project Planning

Basic public services, like water or energy supply, are high on the national and local governments' agenda. But an investment project supporting priority services does not necessarily mean that it should be large and technically complicated. So the first task

to avoid grand corruption is to *minimize the chances of unnecessary investments*, the so-called “white elephant projects.” Service contracts should avoid creaming off, that is letting the most profitable parts of the service to private entities and leaving the most expensive ones in the hands of the government (e.g., dividing the city by population density for municipal solid waste collection contracts).

The selection of appropriate and low-cost technologies also would require careful financial planning and cost-benefit analysis. In the case of infrastructure projects partially financed by user charges, affordability of the service delivery arrangements and the necessary subsidies for the poor have to be assessed, too. Otherwise, technical designers and politicians, who are also interested in highly visible, large-scale projects might easily make deals at the users’ expenses.

When capital investments are part of the partnership agreements, ownership of assets should be clarified in the planning stage. This includes separation of rights and obligations on using buildings, equipment, machinery, and vehicles. It should go with the regulation on maintenance standards, accounting for amortization, and any damages and repairs. Setting these rules in advance will prevent future discussions and consequently will lower the risk of corruption.

For keeping technologies simple and financially feasible, first the planning process has to be *open to the general public*. All groups of the community should be included, especially the poor and other disadvantaged groups.

The planning of complex service management projects should also incorporate the design of the approval processes in tendering and implementation. Environmental licenses are critical conditions of new projects, so getting these preliminary or final permits is another point where bribery may take place. Here, corruption perceptions surveys of the general public and technical experts might help to identify the overall risks and the specific points of corruption.

4.2.2 Project Design and Task Identification

The formulation of project specifications is usually preceded by a *feasibility study*, which will limit the options for the detailed technical and financial planning. Consultants working on the feasibility study should not be connected in any way to companies later intending to take part in tendering. An improper selection of consultants and designers will increase the danger of biased specifications or over-design.

The tasks of the future tender might be specified in two basic ways. In the case of simple services, when the *required inputs* are clearly identifiable, they are specified by the tender document. Here, their offer sets only the prices of the items specified by the bill of quantities. This makes the comparison of the bids easier and will lower corruption risks.

The other basic strategy is when the *performance* (outputs) is set by the tender document. In this case, the entity submitting the tender has greater autonomy in offering the input combination, technology, and price. This specification of tasks can be used either

for simple service contracts (e.g., park maintenance) or for more complex projects (e.g., building a solid waste landfill). In this case the comparison of bids is more complicated as the proposed solutions and the applied technologies have to be compared. The risk of corruption is transferred to later steps: inspection, monitoring, and possible contract modification.

The preparation of the request for tender should specify all the conditions for submitting proposals. Information on infrastructure projects should go beyond the technical specifications; the bidders should be allowed to visit the sites and to receive clarifications. It is important to regulate the *publicity* of all this information to ensure an equal position for bidders.

4.2.3 Submitting Proposals and Awarding Contracts

Before bidders are able to respond to the request for tender, several other conditions of contract awarding have to be defined: the deadlines, the forms of preparing proposals, the period of validity, any modification, withdrawal, and notification. On the requestor's side of the tender opening and evaluation process, the evaluation criteria and the selection should be set in advance. An independent assessor monitoring the entire process of tendering and contract awarding might be appointed as well. Usually a draft standard contract is also provided as part of the tender documentation.

Even the most perfectly regulated procedures cannot entirely eliminate corruption. One potential cause of risk is on the *client's* (the government's) side. A conflict of interest might occur, when government officials, councilors, the mayor, or the administrative staff have a personal business interest. Here only internal codes of conduct might lower the risk. National regulations on post-public employment could also make the rules of tender clear. On the *bidder's* side there are the dangers of market division and creating cartels, which cannot be easily prevented. Declarations on not using bribes and putting no-corruption clauses in contracts might strengthen the legal base of using proper tendering techniques.

The *tender evaluation* should not only be based on transparent, preset criteria, but the process has to be open too. Here, the tender evaluation committee plays a critical role, for example, by opening the offers publicly. The documents submitted by tenderers are not always public and they might contain confidential business information. However, a decision on contract awarding has to be publicized and the contracts are public documents. As with any other government action, they should be under the regulation on access to public information, which overwrites the business confidentiality rules.

4.2.4 Customer Relations: Pricing Policy and Managing Complaints

As customers are in direct contact with service organizations, the relationship between the users and the service provider has to be regulated. Here, the main sources of corruption are the user charges or other payments (connection fee, repair work).

Metering should be the basis of pricing, because any proxies of water consumption might be subject to disputes.

Two component *tariffs* (flat and volume-based) are usually used, and block tariffs (by quantity of consumption) might minimize the corruption. All these methods of sophisticated user charges will work well if the *revenue administration* (billing and collection) is organized in a transparent way.

Channels for customer complaints have to be set up by the service organizations and by the government. They are about reporting on service quality, the need for repair work, disconnections, and problems with billing. They might serve as indicators of service quality on the client's side. At the companies they will prevent illegal payments for connections and repair work.

4.2.5 *Contract Monitoring*

Complex, large-scale construction and service delivery projects require professional inspection and monitoring capacity on the client's side. Savings achieved through contracting out and private sector incentives should be used partially for establishing strong control and audit mechanisms on the client's side. Otherwise the benefits of working with the private sector cannot be realized. The task of the service contract monitoring unit is to detect any substandard work or delays in contract implementation. Their job is to prepare the technical conditions of any contract variation or amendment and the possible agreement on the contract extension. Obviously, a direct and frequent connection with the contractor makes this position exposed to corruption risk.

5. What to Do against Corruption in Procurement?

Procurement in a wider sense includes various forms of the relationship between the public and the private sector, as they were discussed in the section above. Public procurement is used for acquiring goods, supplies, for contracting out, and complex forms of public-private partnerships. In this broader sense, the value of public procurement reaches 15 percent of GDP in the average of OECD countries (OECD 2007). This is a huge amount, so any anti-corruption program might bring significant results in financial terms and also in increased trust in governments.

The methods of fighting against bribery and proposed techniques of curing corruption are the focus of international organizations, multinational development banks, non-governmental organizations, and obviously national governments. During the past decade several guidelines, recommendations, good practice databases, and pieces of legislation have been prepared. (For examples, see the relevant websites among the sources cited.) These counter-measures follow a similar logic, so by now there is a

consensus among analysts and practitioners on the main areas of anti-corruption actions in procurement.

The starting point of these proposed methods is that only *coordinated actions* will result in a decline in corruption. There is a general shift from procedural aspects of procurement towards focusing on improved knowledge and greater *professionalism*. Improved understanding of the nature of their businesses will make the public authorities and their civil servants better managers of the entire procurement and contract process.

As the infrastructure and other public service contracts depend on the *external institutional environment*, remedies for corruption should target the following reforms (Cavil and Sohail 2006). Macroeconomic reforms through the opening of domestic markets, de-monopolization, and deregulation might create favorable conditions for competition and consequently for lower corruption risks. In the public sector civil service reforms and decentralization will improve accountability. External public pressure on both actors (businesses and governments), exercised by better informed citizens and civil society organizations, will contribute to decrease in corruption. Finally, increased chances of being punished for corruption and judicial reforms are also needed for comprehensive anti-corruption policies.

However, there is *no general solution* for all the problems related to corruption. Countries are different by the level of corruption, the quality of governance, and the local culture towards partnering between the public and the private sector (Stalgren 2006). So in countries with a low level of corruption and a relatively developed governance, the new anti-corruption agencies, better diagnostic measures, greater public awareness, and initiating high profile legal steps might work. However, in countries where corruption is high and the quality of governance is low, the decentralization of government, training, awareness raising on the costs of corruption, citizens' charters, and stronger financial control will bring results.

Anti-bribery actions in procurement focus on the following areas:⁴

- *Prevention* measures might target: the competition rules by opening up the market for service; the civil servants by providing training for them, introducing ethical codes, and post-employment standards; and the regulatory institutions by developing independent agencies. Simplified procurement procedures, together with improved transparency and use of diagnostic surveys, will decrease the corruption risks.
- *Control* mechanisms, both internal and external, should be made more effective. Here, the protection of whistle-blowers, independent audits, the use of third-party information sources, and horizontal control mechanisms (chambers, professional associations) will improve the efficiency of monitoring and control.

- *Detection mechanisms* on corruption are needed to do the filing and reporting on bribes and to launch legal cases. Competitors, independent auditors, NGOs, and international organizations should be able to draw the attention of the governments or the general public to any irregularities.
- *Investigations* and *sanctions* might be initiated by the agency responsible for procurement or any parties involved in the tender. In general, overregulated procedures might be counterproductive and will not lower significantly the level of corruption. However, independent investigations from other professional areas, international organizations, and strong domestic enforcement mechanisms will improve the impact of legal actions.

Combined efforts of various types will enhance the general accountability in the public sector. Consequently they will have an impact on corruption in procurement, contracting out, and other forms of public-private partnership. A better understanding the nature of the public-private partnerships and more informed public officials on the rules and incentives of the private sector will help to decrease the risk of corruption. As a general rule for working with the private sector, it can be stated that the transparency of government actions is insufficient, but public decisions should be also seen as open ones.

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Relevant Websites

Anti-corruption Network for Transition Economies: <http://www.anticorruptionnet.org/indexgr.html>.

Anti-corruption Resource Center: <http://www.u4.no/>.

Business Anti-corruption Portal: <http://www.business-anti-corruption.com/>.

Doing Business, benchmarking business regulations: <http://www.doingbusiness.org/>.

Freedom of Information: <http://www.justiceinitiative.org/activities/foifoe/foi>.

Global Integrity, Independent Information on Governance and Corruption: <http://www.globalintegrity.org/>.

OECD Anti-Corruption Network for Eastern Europe and Central Asia: http://www.oecd.org/pages/0,2966,en_36595778_36595861_1_1_1_1_1,00.html.

PEFA—Public Expenditure & Financial Accountability: <http://www.pefa.org>.

Reports on the Observance of Standards and Codes (ROSCs): <http://www.imf.org/external/np/rosc/rosc.asp>.

Stockholm International Water Institute: <http://www.siwi.org>.

Transparency International Integrity Pact: <http://www.transparency.org/tools/contracting>.

WIN—Water Integrity Network: <http://www.waterintegritynetwork.net/>.

World Bank, Governance and Anticorruption: <http://web.worldbank.org/>.

Notes

¹ Lower percentages in the table mean that respondents pay more.

² See: <http://www.waterintegritynetwork.net/page/188>.

³ See: <http://www.siwi.org>.

⁴ Based on OECD 2007.

Integrating Public Property in the Realm of Fiscal Transparency and Anti-corruption Efforts

Olga Kaganova

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Abstract

This chapter discusses a relatively new area of public management: how management of government-owned property assets can be made more transparent and efficient, under a larger umbrella of fiscal transparency and anti-corruption within public management. The chapter starts by demonstrating that government property assets constitute a lion's share of public wealth, which has been substantially overlooked by traditional financial management and also traditionally subject to conflict of interest and corruption. Then it reviews specific channels that typically lead to forgoing public benefits, from honest incompetence to influence of politics to corruption and favoritism. Further, the article presents the conceptual frameworks for reforming asset management at the central and local governments, with both being drawn from experiences of advanced reformers, such as Australia, Canada, and others. It illustrates how the framework for local governments has been applied in practice in Croatia. The chapter then reviews the systematic transparency and anti-corruption safeguards that can and should be introduced in municipal asset management, such as transparency of information on municipal assets, competitive procedures, better financial management, and attention to the governance of municipal enterprises. It concludes with a discussion of the issues that require further public debate: pros and cons of property devolution to local governments, a special legal regime for public property, leasing of surplus public property, balancing the regulatory regime between the central and local governments, and the "de-politization" of asset management.

1. Introduction

Governments own an impressive range of property: real estate (land, public housing, water distribution systems, roads, office buildings, etc.); movable property (vehicles, equipment); and even whole enterprises. While thinking about governmental property, it is useful to keep in mind two important aspects—legal and financial. The legal side is related to how governmental ownership of property is defined, documented, and protected. It also defines whether and how governmental property can be alienated (sold, leased, mortgaged), and what kind of limitations exist on uses of governmental property, etc. The financial side is related to a very broad area of how governmental property is (or is not) incorporated into financial reporting (accounting) and financial planning (budgeting). In accounting terms, from the balance sheet viewpoint, real estate and movable property constitute fixed (or capital) assets that are, as a rule, the main part of non-financial assets on governmental balance sheets. Such particular types of capital assets like land, buildings, infrastructure, and equipment are usually distinguished as separate lines on the balance sheet, while other types are often added, depending on local specifics (for example, a specific asset type can be “art work” or “municipal housing”).

Asset management of public property is understood as the process of making and implementing decisions about property acquisition, use/management, and disposition. Until very recently, public property asset management had been very untransparent, inefficient, and insufficiently integrated in public financial management even in the most developed countries and their cities. Over the last decade, however, new approaches to public property have emerged that apply standards of economic efficiency and effective organizational management.

This chapter discusses a specific range of issues related to integration of public property asset management into fiscal transparency and anti-corruption efforts. The chapter considers issues related to property owned by all levels of government (central, local), but also focuses on some specifics associated with municipal property (property of local governments).

2. Why Is Integration Important?

Fiscal reasons. To appreciate importance of government-owned property, it is useful to look at governmental balance sheets. This would immediately demonstrate a fundamental fact: public property represents the largest portion of public wealth even in countries that slimmed down their property holdings. For example, the federal government of Australia, which is among the world’s few advanced reformers of public asset management and privatized very large portfolios of governmental property (Conway 2006), by mid-2003 still had 48.3 percent of the value of its assets held in non-financial assets, mainly infrastructure, equipment, land, and buildings. At the level of local governments,

at least urban, the share of non-financial assets among all assets is normally even higher. It varies from 50 percent to 99 percent of the total balance sheet, as examples below demonstrate:

Table 1.
Value of Capital Assets, as Percent of Total Assets on City's Balance Sheet

City	Value of Capital Assets, as Percent of Total Assets on City's Balance Sheet
Dallas, Texas, USA (2003) ¹	81.4%
Varazdin, Croatia (2000) ²	60% (plus 8.3% in shares in companies)
Ostrava, Czech Republic (1996) ³	93.3% (plus 6.2% in shares in companies)

In post-socialist countries, there are additional specifics that magnify the importance of public property, especially for local governments. First, the value of public property compared to an annual public budget can be substantially higher than in developed market economies. Second, the authority of local governments over their municipal property is often higher than their authority over their budgets. This happens because fiscal decentralization is not completed yet in many countries. Local governments do not have truly independent local budgets and taxes, but they can acquire and dispose of municipal property quite independently.

Unfortunately, there are endless examples illustrating that governments of all levels in all types of economies often underuse the fiscal potential of their property. A common systemic problem is that the principles of good financial management are not applied to public property assets, except in a few of the most advanced countries (Australia, New Zealand). As a result, the following weaknesses are typical for property asset management:

- Property-related expenses are neither monitored nor managed in any systematic way. High administrative costs are usually not recognized, not monitored, and not managed (for example, administrative duplication and fragmentation of asset and property management and low productivity of public employees).
- The revenue potential of public properties is substantially underused. This is a problem worldwide, and not just in former socialist economies (for example: obsolete properties are retained in governmental ownership instead of being privatized; public property is leased out to private tenants at prices below market; etc.)
- The true market value of assets is not recognized and not maintained (there is huge deferred maintenance and repair associated with public property everywhere, which leads to loss of public wealth concentrated in real estate).

On the other hand, some local governments (for example, in some Chinese cities) have been very entrepreneurial and managed to unlock the market value of their lands and leveraged this value for raising capital investment in urban infrastructure, sometimes using their monopolistic position in land supply for going further than would be prudent (Peterson 2006).

Corruption and conflict-of-interest related reasons. Another fundamental reason for integrating management of public property assets into systematic anti-corruption efforts is that this area or public management has been traditionally known as prone to corruption, abuse, and conflict of interest. Cases vary widely—from legal but bad practices (for example, political parties that won local elections providing free-of-charge municipal premises for themselves in Serbia), to direct corruption associated with allocation of municipal vacant land, built-up properties, and contracts to private sector actors.

Moreover, this traditional reality turns to be reinforced by the existing regulatory environment. A recent study by Barbara Kudrycka (2004) in six countries (Bulgaria, Latvia, Poland, Romania, Russia, and Slovakia) revealed that the use of municipal property is among the least protected from conflict-of-interest abuses, comparing to other areas under the jurisdiction of local governments.

3. Causes and Channels of Forgoing Public Benefits

It is important to recognize that inefficiencies in public property asset management take place for many reasons, and not necessarily because of corruption. At the same time, inefficiencies of all types unavoidably translate into forgone public benefits, regardless of whether or not this loss is evaluated in financial terms. Therefore, measures for mitigating inefficiencies should aim for removal or reduction of all types of inefficiencies, and not only the criminal part of the “inefficiency spectrum.” The following classification covers most causes and channels of forgone public benefits:

- **Honest incompetence.** Managing highly diversified portfolios of public real estate requires quite sophisticated professional qualifications, while governmental employees tasked with property asset management usually do not have even a basic background in property and portfolio management.⁴
- **Lack of proper incentives for public sector agencies and staff.** One of the most common examples is a direct disincentive for governmental agencies or levels of government to privatize surplus real estate: proceeds from property sales go fully or by a substantial part into budgets of other agencies or levels of government. This situation has been typical for both developed countries and transitional economies. In addition, local governments in countries in transition often have

another disincentive for property privatization: they do not have much control over the property tax imposed on privatized properties, but may define lease rates if they retain properties in municipal ownership and lease them out.

Another universal disincentive is that compensation of governmental employees in most countries does not depend on their performance. In particular, it does not depend on whether they manage their properties and property portfolios efficiently or not.

- **Inadequate legal and regulatory environment.** As a rule, until efficiency-oriented reforms of public asset management are introduced, historically-developed laws and regulations are simply not relevant for efficient asset management. This is true for most developed countries, including the USA and Roman Law countries (France, Switzerland, etc.), where the body of law has been developing historically based on social values and principles that are different from economic efficiency in the public sector. In other words, from the efficiency viewpoint, this area of public management is either overregulated or underregulated, or both at the same time. Only recent, consciously-designed reforms (for example, in Australia, New Zealand, the UK, and, to some extent, France) started introducing economic and financial efficiency as a basis for the regulatory regimes related to public property. In transitional and post-transitional⁵ countries, the regulatory regimes are far from being balanced as well.
- **Influence of politics.** Politics are very much at the heart of government decision-making when it comes to managing real property assets. Politics set this area apart from the private sector and make it difficult to apply asset management models from the private sector. As Hentschel and Utter (2006) acutely noted, eliminating political influence from governmental decisions “is like removing sand from the beach.” Politicians often have legitimate and appropriate concerns about the management of public property, from promoting economic development to responding to concerns of their constituents. As a result, policy priorities may lead to solutions regarding governmental real estate or investment not optimal from purely financial and real estate viewpoints. At the same time, there are numerous examples all over the world when politics lead to decisions that do not represent—in any sound way—public interests or public policy. In addition, there is an obvious timing gap between a relatively short political cycle and the substantially longer time needed for strategic asset management.

So, what should emerge as a subject of public debate is whether it is feasible and desirable to introduce binding policies, rules, and regulations related to asset management that would reasonably protect public property from decisions stemming from partisan or biased politics. It seems that regulations regarding federal property in Australia provide

a promising illustration that evolution in this direction is feasible (Conway 2006). It is also useful to note that countries and cities in Eastern Europe can become a major world laboratory in this area, because their asset management practices are less loaded with historically-rooted approaches.

- **Legitimized conflicts of interest.** Quite often, the legal actions of governments or governmental officials constitute what certainly can and should be recognized—from the public interest and efficiency viewpoints—as bad practices or direct conflict of interest. For example, in Serbia, political parties that win at local elections then headquarter themselves in business premises in municipal buildings (usually, at prime downtown locations), as free-of-charge tenants. In Croatia (at least, until recently), local officials could legally own up to 25 percent of shares in municipal companies.
- **Corruption and favoritism.** Corruption and favoritism in the area of public property is such an old story that it has made its way into literature classics.⁶ No doubt, societies across the world are trying to curb this area of corruption, in particular by introducing laws on competitive and transparent public procurement. However, corruption associated with public property, and, in particular, with sales, leases, and other forms of allocating rights in public property to private economic actors is still alive in many countries. It remains a major problem in most post-Soviet countries, some transitional countries in Europe, and China.

4. Approaches to Protecting Public Interests, Increasing Efficiency, and Reducing Corruption

Obviously, increasing efficiency in such a complex area as property asset management and curbing corruption requires actions along many lines. Furthermore, there are specific tasks associated with different levels of government. Finally, a focus on protecting public interests brings to the forefront the public debate on specific issues.

4.1 Reform Framework for Central Governments

The issue of increasing overall efficiency of asset management has been the focus of asset management reforms undertaken in several countries. The generalization of their experiences allows the creation of a “composite image” of the reform framework applicable to property assets of both central and local governments (in the latter case—with some modifications):⁷

4.1.1 Explicit Public Policy

Reform measures must be driven at the highest level of government by a clear, explicit policy framework applicable to all public real assets under control of a particular level of government (central, local).

4.1.2 Recognition of the Cost of Fixed Asset Ownership and Use

It is no longer acceptable to view public property as a “free good”; there is a cost associated with its use and this cost must be recognized and managed explicitly. There is broad consensus that the cost of operating and maintaining fixed assets—especially office accommodation, infrastructure, vehicles, and office equipment—should be recognized and addressed explicitly. Occupancy costs—implied or actual rent—also tend to be recognized, but some countries do not apply this to all publicly-owned office space. There is more variation in the approach to recognizing and managing the costs associated with the ownership of fixed assets. This includes three separate issues: the valuation of the asset, depreciation, and the cost of capital. Consistent with the focus on the opportunity cost of holding a fixed asset, most of the country-reformers have instituted a continuing process of identifying assets that are no longer needed or where ownership is no longer justified on economic grounds. In these cases, there is a process for disposing of the assets, usually at or near market prices. Finally, life-cycle costing is used as a practical and effective way to manage the costs of asset ownership and use. This technique looks at all phases of ownership of an asset, encompassing acquisition, ownership, and disposal, and includes not just the production or acquisition costs, but also costs to operate and maintain the asset.

4.1.3 Information Systems

The lack of data or incomplete data is a major impediment to launching any reforms. Not knowing exactly what government owns, the occupancy levels associated with each property, property characteristics, operating costs, and maintenance requirements is an immense barrier to progress. Information should be relevant to overall approaches to reformed asset management and has to be effectively managed. However, specific approaches to asset management information (in particular, its centralization or decentralization) vary across the breadth of countries- and cities-reformers.

4.1.4 Accountability Mechanisms

Accountability involves overall stewardship of assets, and this means effective mechanisms to measure results and an accounting system that will drive effective decision-making at the level of the custodian. Government must be able to hold asset managers accountable for the assets in their custody and be assured that these assets are serving their intended purposes and achieving targeted results.

4.1.5 Decentralization of Management Responsibilities/Strengthening Central Leadership Role/Incentives

In general, countries-reformers have delegated a lot of authority to individual institutions and agencies. However, this decentralization is carefully paired with various incentives and penalties (or performance benchmarks) built into the system along the whole chain to stir decision-making at and performance of asset-managing entities toward effective implementation of policies and principles established centrally.

Concurrently with the decentralization of management responsibilities, these countries have moved to strengthen the role of the central policy and monitoring and evaluation functions. As much of the policy oversight is accomplished through an overall budget process, it is often a central institution that assumes the policy function, such as the Ministry of Finance in Australia or Treasury Board in Canada. Audit agencies, such as the Auditor General in Canada or the National Audit Office in Australia, have an important role in advocating the need for the reforms and program monitoring, although the audit function has no decision-making or policy formulation responsibilities. Both the budget and audit processes maintain a continuing process of evaluation, as all countries recognize that their reforms are breaking new ground where there are no sure and proven performance benchmarks.

Another important instrument for leading reform, especially on technical issues, is the involvement of professional organizations that often help the central government entity that leads the reform to identify technical issues that should be addressed and to develop related guidance and standards.

In new systems of decentralized management, the central institutions with broad functions of asset management do not necessarily disappear, but their procedures have been modified and adjusted to be more consistent with a system of decentralized management. For example, in Australia, the Property Management Branch within the Department of Finance and Administration also works in a competitive market since the governmental tenants are not forced to use the services offered by the Branch's asset manager, United.

4.1.6 Privatization Initiatives

“Privatization” involves two separate initiatives: asset disposition and private asset management. Asset disposition is the identification and disposal of assets not required for government programs and functions (surplus property), and private asset management is the engagement of the private sector in managing government-owned assets, where cost savings and efficiency in the delivery of services by the private sector are demonstrated clearly.

Asset Disposition. For varying reasons, governments are prone to retain control over economically or functionally obsolete assets (such as military bases that date back to the Second World War or, in transitional countries, assets from social and commercial activities that are no longer under government control) or engage in acquisition/investment projects not needed for their core activities and programs. These surplus assets are an important case, and the experiences of the countries-reformers have common threads that provide examples of possible approaches to the issue:

- *Clear policy guidance to help identify what assets fall into the surplus category.* Identification can be according to a broad statement of principles as in the case of Canada, or more specific quantitative or detailed guidance as in the case of Australia. The point is that a government must explicitly declare that it will not retain ownership of assets that are not required for its programs. Typically, these policies will also apply to the acquisition of new assets so that the government does not continue to accumulate surplus or unproductive assets.
- *Clear, written rules for the disposal of surplus assets.* These rules can be a specialized law that assigns responsibilities and defines procedures for asset disposal. In the four Western countries studied, the disposal must be at market prices, except in the case of explicit circumstances that require special authorization.
- *Some countries have established a special agency that is responsible for putting the assets on the market.* In some cases, this agency may take some preliminary steps to prepare the asset for the market in the expectation that this will enhance its value.

Private Asset Management. Reform governments have sought not just to import best practices for management of real property assets from the private sector, but to actually turn over management responsibilities to private sector firms and to sometimes remove themselves from these tasks completely. This removal ranges from the outsourcing of selected services, such as property management or brokerage, to the wholesale transfer of asset management and property management responsibilities like in Australia.

4.1.7 New Accounting Practices

Traditional cash accounting may have served the central requirements of public budgeting but it did not enable sound decision-making among asset managers. The move to accrual accounting and the requirements for asset valuations began to address a number of weaknesses typical for cash accounting.

The experiences of advanced reformers demonstrate that implementation of comprehensive asset management reform at the central government level takes substantial time (years, if not dozens of years) even in countries with a strong and consistent political will to proceed. The biggest challenge—and perhaps biggest differences among countries—is related to sequencing the elements of reform.⁸

4.2 Municipal Asset Management Framework

Guidance on municipal asset management is an urgent necessity because in former socialist countries, public property has been decentralized on a grand scale as a part of government decentralization. Among 26 countries in Central and Eastern Europe and the former Soviet Union, about three-quarters have legally established a separate form of property—municipal property (Kaganova 2006). There is no comprehensive statistical or fiscal information on property transferred into municipal ownership (Peteri 2003), but all empirical evidence shows that local governments in most countries became owners of huge property portfolios—directly and through ownership of communal and utility companies. A useful framework for municipal asset management was suggested in some Urban Institute publications (for example, Kaganova, Undeland 2006) and is reproduced below (Box 1).

Box 1.

Framework for Municipal Asset Management

Inventory Component

- Develop and maintain comprehensive records of properties owned by the local government (including properties managed and used by various municipal departments and enterprises)

Property Management and Accounting Component

- Develop and maintain a property management and accounting system on a property-by-property basis (including all revenues, costs, and occupancy / tenants' records)
- Include the value of each property in the accounting database, and include financial liens against each property
- Formalize in writing the relationships regarding property with all tenants/users of municipal property
- Use private-sector property management approaches for improving public property management

Asset (Portfolio) Management Component

- Formulate a strategic role of real estate in attaining municipal goals
- Develop classification of property by its role in performing governmental functions and apply this classification while conducting an inventory
- Develop and use class-specific financial tools and performance standards
- Monitor property and portfolio financial performance
- Implement a portfolio management approach, including proactive management of social use and surplus portfolios
- Make transparent rules on how municipal property (including land) is allocated to third-party (private, non-governmental) users
- Develop and implement policies aimed at rationing property demands and consumption by governmental departments and social users
- Make asset management accountable through regular reporting

Box 1. (continued)
Framework for Municipal Asset Management

Strategy Implementation Component

- Establish a centralized real estate authority with overview or direct control over asset management
- Devise written policies and decision-making roles for the acquisition/holding/disposition of assets
- Develop in-house real estate expertise and use outside real estate professionals as needed
- Set up incentives for more efficient use and management of municipal property assets

It is important to emphasize that effective use of this framework implies that municipal property has a reasonable autonomy and a legal and regulatory base established by central government. It is also useful to notice that the frameworks in the previous section and in Table 2 overlap conceptually to a very large extent (for example, both recognize the need to have explicit policies, incentives for asset managers, inventory records, etc.).

Again, as in the case of the central government reform, the framework in Box 1 is quite ambitious and requires time to implement. However, any local government can select items from this “menu” that have the highest priority in local circumstances and are politically and administratively feasible to start with. This “tailored to local realities” approach proved to work well in a number of transitional countries (Croatia, Kyrgyzstan). For example, a sub-set of activities from the above list was implemented, in various degrees, by several cities in Croatia (Varazdin, Split, Rijeka, Karlovac, and others) as the “Initial Asset Management Model” that included 11 elements (Box 2).

Box 2.
Croatian Cities: “Initial Asset Management Model”

1. Introduction of an information system on a property-by-property level
2. Transitional issues
3. Property classification
4. Real estate and business appraisal
5. Operating statements for income-generating properties or portfolios
6. Intensive financial analysis of portfolios, properties, and projects
7. Deregulation of business rentals and improvement of rental practices
8. Quantification and monitoring of direct and indirect property-related subsidies obtained by tenants and users of local government’s real estate
9. Reporting on property
10. Management consolidation
11. Comprehensive asset management plan

4.3 Focus on Transparency, Anti-Corruption, and Overall Efficiency

Even for countries with established democracies and developed economies, improving management of public property assets represents multiple challenges. Is the task daunting and impossible for countries with emerging democracies and transitional or developing economies, and in particular, for their local governments? Not really—there are approaches, instruments, and techniques (some of them relatively simple) that can truly improve the anti-corruption climate and overall efficiency.

Box 3.

Power of Information Transparency

An inventory of municipal land in one of Kyrgyzstan's cities revealed that 86 hectares of municipal land were allocated to 178 various private land tenants (legal entities and physical persons) free-of-charge, which was against the law and also represented a substantial portion of land, given that land leases made up only 11.5 hectares. When this information was presented to the mayor, he paled, literally, because he immediately recognized negative legal and public relations implications—in addition to forgone revenues for the city budget.

Many violations of public interests on the corruption and conflict-of-interest end of the “inefficiency spectrum” take place at specific moments in the property life cycle: (i) property acquisition (or other capital investment, such as reconstruction), (ii) property disposition, and (iii) allocation of partial rights in property to third parties (use, lease, transfer to municipal enterprises). This is where anti-corruption mechanisms should be built into the asset management process (Peteri, Schaeffer 2007).

Some of main anti-corruption and efficiency-oriented approaches are suggested and discussed below, with a focus on applying them to municipal property.⁹ However, similar approaches are applicable to property owned by other levels of government as well.

4.3.1 Introduction of Systematic Transparency into Municipal Property

This, in turn, should proceed along a number of directions:

- Transparency of Information

Pure facts about municipal property, if properly disclosed, constitute a very powerful instrument to make local governments accountable (Box 2).

Specifically, for the transparency of information, we recommend:

- An inventory municipal property assets (buildings, land) directly controlled by local governments and budgetary organizations. Open the inventory records to the public and mass media

- Establish, maintain, and open to the public and mass media:
 - A directory of all tenants (users, lessees) of public property (including land), with key characteristics of tenancy (for how long, at what price/ payment)¹⁰
 - A directory of all acquisition and disposition transactions with public property (from whom acquired, for which price, and through which procedure; similar for dispositions)
 - Quantitative, project-by-project information on municipal capital investment and borrowing
- Introduce at least annual reports on municipal property, which would be presented to local elected councils, published, and made available to the public; they should be quantitative and specific and summarize information on property portfolios, transactions, and investment.
- Transparency of Procedures and Decisions

All rules regarding allocating public property to non-governmental users should be in writing and made available to the public. Further, the public should have access to key events related to public property, such as meetings of city government and auctions or opening of sealed bids.

It is impossible to overestimate the leading role that mass media and watchdog groups can play in building public demand and expectations regarding transparency. At the same time, a requirement of public disclosure of information and opening procedures to the public should not be left to journalists alone and should be codified in law, as discussed further.

Further, broad awareness and education campaigns are needed: even for formulating requests for information or disclosures or asset management reports, some technical knowledge is needed that is lacking in most countries in general. Hence, there is a strong need to educate governments, the public, watchdog groups, and mass media.

4.3.2 Use of Competitive Procedures

All real property purchases, sales, and leases to non-budgetary tenants should go through competitive procedures and at market prices. It is important to notice that here lies one of the important differences between countries with low corruption (such as New Zealand or Australia) and countries more prone to corruption. In non-corrupt countries, it is sufficient to require that public property is disposed at market prices estimated by independent appraisers, but not necessarily through open competitive procedures. In countries with high corruption, use of independent appraisers does not work well, and open auctions or sealed bids are an absolute necessity.¹¹

4.3.3 Adherence and Enforcement of Existing Laws

A common problem is that even laws that already exist and should protect public interests are often not followed in local government practices. Specifics vary broadly, but here are some examples:

- Competitive procedures of leasing and selling properties are required but not applied.
- Income from property sales (capital income) has to be used for capital investment, but instead is used to cover deficits of operating budgets.
- The public is not informed and not admitted to local government meetings approving property decisions.

4.3.4 Attention and Spotlight on Municipal Enterprises

Municipal enterprises are the least monitored and supervised part of local government asset management (Hegedus 2004; Kasso and Pergerne-Szabo 2004). This has led to massive loss of potential revenues for public budgets and loss of assets, as reviewed by Olga Kaganova (2006). Improving governance of public enterprises and finding alternatives to them (such as outsourcing service provision to the private sector) is one of central challenges of asset management. Discussing this topic would go well beyond the scope of this paper. However, some general directions are: inventorying assets, improving financial management and reporting (in this case, to a founder, local government), and fully disclosing to the public the assets and financial performance of the enterprises.

4.3.5 Improving Financial Management of Public Property

This is a broad technical issue. The core idea, however, is that a large portion of honest inefficiencies in asset management originates from the fact that financial management of property assets does not exist in local governments. For example, as indicated in the beginning of this chapter, local governments do not know and even do not try to know the full operating and maintenance costs associated with each property (building, facility). Rational and efficiency-oriented decisions are impossible in such a situation.

4.3.6 Creating Competitive Pressure, Deregulating Property Use and Prices, Attracting Professionals and the Private Sector

These elements are all important for increasing efficiency. Given the enormity of work that should be done to improve efficiency of asset management, it is important to start some key efforts—such as monitoring operating expenses on a property-by-property basis or outsourcing municipal services to private providers—from properties and services where most fiscal benefits can be expected, without high risks involved.

5. Issues for Further Public Debate

Reforming management of governmental property assets is a clearly growing area within public sector reforms. It has a broad span, from policy and technical debates to experimentation with various instruments and techniques, including such advanced instruments as public-private partnerships and private finance for public infrastructure. Some issues have been revisited over time, due to the evolution of broader views on the public sector's role and accumulation of new evidence. Furthermore, reforming public property asset management is an ongoing process that brings new challenges as it proceeds.

1. *Should devolution of property from central to local governments take place, especially given multiple evidence that local governments often do not do a good job of managing property assets?* Regarding real estate, the answer seems to be “yes,” from both viewpoints: efficiency and anti-corruption. Real estate is always a local matter, and it is impossible to manage properties efficiently from the capital. Besides, holding local officials accountable for property mismanagement is easier than a faceless somebody in the capital. A couple of recent examples can illustrate this point (Box 4).

Box 4.

Is Central Government a Better Owner than Local Government?

Serbia. Municipal governments have to request permission from the central government agency to terminate any lease agreement, even if it is just for 15 square meters in a basement, and tenants chronically do not pay rent. Such requests go unanswered for months, if not years. This nullifies any economic efficiency of surplus rental property.

Kyrgyzstan. One city government was asking the central government to transfer a movie theater into municipal ownership, which had been non-operational for several years. The local government was going to convert the building into a multi-functional public center. However, the central government continued to retain the property, without providing any maintenance or security. When the city mayor took the author of this paper to the site, the building had been deconstructed and stolen brick-by-brick down to its foundation.

An important caveat, however, is that governments (at any level) should not be encouraged to retain surplus properties and should be de-incentivized to do so.

Regarding municipal services, such as water supply, the answer is not obvious, and the issue is a subject of hot international debates. In many low-income countries, local governments do not have the expertise or capacity to govern and operate water companies, and other models can be more efficient.

2. *Is a special legal regime for public property justified?* Many Western European countries have a special legal regime applicable to property used for public purposes—property in “public patrimony” in France or “administrative” property (“*patrimoine administratif*”) in Switzerland. Property of this type is, in general, not alienable, i.e., it cannot be disposed of or used as collateral and also may have limitations on use and management arrangements. However, there are special procedures that allow removal of property from public patrimony. For example, in France, this can be done by either enactment of special legislation or through a two-step process of declassification from the public domain (Bizet 2006). Governments in most such countries may also own properties subject to a private sector law (i.e., regarding these properties, rules are the same as for private property owners). Which particular properties are included in the public patrimony varies by country. For example, in France, marketplaces are in public patrimony, while in Switzerland they are not.

In the beginning of the transition in Central and Eastern Europe, some experts from Western Europe strongly discouraged the use of the “public patrimony” concept in transitional countries as highly inefficient economically. Their reasoning was that economic realities require regular changes in property use (for example, due to changing demographics, a school building might be not needed anymore), while the declassification from public patrimony is a long and expensive process, largely reducing economic efficiency associated with governmental property.

Nevertheless, some countries in Central and Eastern Europe (at least, Bulgaria, Czech Republic, Hungary, Romania, and Slovakia) reproduced this concept, in one form or another, while introducing laws on municipal property. Some researchers later discussed that in Hungary this concept did not seem to add to the security of public property, because declassification can be easily performed by local governments (Kasso, Pergerne-Szabo 2004).

Box 5.

Inefficient Portfolios of Municipal Rental Properties

One Croatian city, when its government decided to improve its asset management, made an effort to figure out the full costs of leasing each of its 59 business rentals, estimated market values of these premises, and estimated capitalization rates for each premises. The result was shocking for the managers: it turned out; that 19 out of 59 premises had a negative net income (the city was just losing money by leasing them!), and only nine premises had a capitalization rate higher than five percent. In other words, only nine out of 59 premises maybe made some sense as rentals, in the rational world! This city figured it out and, hopefully, will act upon this knowledge.

The question for further debate is: Given intrinsic economic inefficiencies associated with asset management decisions regarding properties in “public patrimony,”

is the use of this legal form justified by gains in property protection? Can sufficient protection of public interests be achieved under more flexible legal arrangements? For example, should the law require that any disposition or mortgaging of public property be pre-approved by an elected local council?

3. *Lease of public property as a potential source of losses for both public and private sector.* Many local governments in transitional countries tend to retain surplus properties (commercial space, housing) and use these properties for income generation through short-term leasing. Furthermore, some governments prefer retaining urban land in public ownership. It is important to recognize that public ownership of land, with only partial rights (such as lease rights) allocated to private actors, is still dictated by law in some countries (China, Ethiopia). However, in most transitional countries private land ownership is recognized by law, and urban land is already substantially privatized. Nevertheless, retaining land in public ownership and allocating to investors long-term lease rights only continues to be a policy of choice for many local governments, with the City of Moscow being the most famous case. Though proponents of privatization are trying to argue about inefficiencies and other negative implications associated with the broad use of this leasing model, many local governments continue to grip onto surplus built-up properties and land.

No doubt, further education of local governments and the public is needed to demonstrate the types and scale of losses associated with this leasing model. The subject of splitting “legal rights” (retained by government) and “economic rights” (held by leases or investors) has been discussed internationally by real estate analysts, both conceptually (Barzel 1997) and practically (for example, Jieming Zhu 2002). They have demonstrated how the leasing model creates negative implications, including non-productive costs, reduced property values, and inefficient land usage. Examples of inefficiencies are astonishing (Box 4), but often not quantified. Governments—as mentioned in the beginning of the chapter—do not know the full financial results related to their rental portfolios. Hundreds of former socialist cities do not know how much it costs for them to operate portfolios of dozens or hundreds or even thousands of business rentals, many of which produce either direct losses or insufficient returns on investment. Cities also do not monitor how wealth accumulated in this real estate is dissipating (lessees, with their short-term leases, do not have any economic reasons to invest in maintenance and repair).

Long-term land leases have their own specifics for transitional and developing economies, which makes their broad use a questionable public policy (Kaganova, McKellar 2006):

- *The land leasing model is more expensive and complicated to administer.* First, it separates rights in land from rights in improvements on the land (i.e., buildings), which requires establishing and maintaining separate systems for registering leasehold rights of land tenants and their ownership rights in improvements.

Second, governments become holders of large portfolios of lease contracts, and these portfolios must be monitored and managed, which adds to the cost of land management. Third, a single property tax is not applicable because taxation of buildings and payments for land must be administered separately. For transitional and developing countries just establishing their property registration systems and reforming taxation, this model imposes a double burden on both governments and property holders.

- *The land leasing model requires sophisticated legal knowledge on the part of participants.* The lease agreement is a binding contract, and parties entering in this contractual arrangement must be fully aware of their legal obligations under the terms of the lease. This is not something that relatively unsophisticated and small landholders will understand. The quality of the lease itself is crucial. Omission of key provisions—for example, who owns what at the date of termination, or renewal provisions—can lead to multiple cases of litigation or mass protests (there are examples of both). This model is heavily weighted in favor of lessees with good lawyers and shrewd negotiators at their disposal. As a result, the land lease system in less developed countries often unintentionally discriminates against small domestic lessees and acts in favor of experienced foreign interests, quite the opposite of intended goals.
- *The land leasing model assumes a well-established institutional framework.* The success of contractual arrangements depends upon respect for the legal system and an institutional framework that can enforce compliance. However, contractual law is relatively new for many transitional and developing countries and property-related contracts are often violated by all parties including local governments, especially in large cities. Private investors are inclined to distrust lease rights granted by local governments and opt for ownership rights established by law, except where there are incentives attached to the leasing option. Corruption is also a threat to this model, as experiences in many countries, including China and Russia demonstrate.
- *The land leasing model is associated with higher transaction costs.* Trading and mortgaging land leases, where permitted, typically incur higher transaction costs than do trading and mortgaging owned land. Leasing also appears to limit liquidity, because governmental approval—in one form or another—is often needed.

For transitional and developing countries, the accumulated experience of the past 10 to 15 years poses this public policy question: Are there enough clear benefits with the land lease model to justify its use compared with the ownership model? What goals and objectives cannot be achieved with the relatively simpler, cheaper, and more corruption-resistant land ownership model?

4. *Balance the regulatory regime for municipal property between the central government laws and local regulations.* Does an optimum exist? This is a real challenge because tiny but wrongly placed provisions can cause inefficiency. For example, a law on municipal property in Bulgaria required city mayors to sign all lease agreements on municipal premises. Do not mayors have more serious work to do? Would it not be more appropriate to require local councils to develop and approve leasing procedures, which would specify who signs these leases? This area certainly needs more work, and it would be useful to try to develop a prototype of a “rightly balanced” regulatory system. In the author’s view such a system would include three main components:
 - Central government law(s), establishing basic principles and requirements about municipal property and local governments’ rights and obligations as owners. This includes a requirement to have a local (municipal) Ordinance on Asset Management adopted by local elected body (council);
 - A set of prototype documents to be adopted by local governments, including a prototype Ordinance. This set of documents should be developed by a central government or non-government entity and be offered to local governments as not mandatory to use;
 - Local Ordinance on Asset Management and other local regulations—all adopted as documents obligatory for mayor offices (executive branches) to follow.
5. *Recognize importance of written policies.* Good asset management as a sustainable process (versus a push by one progressive person at local government) is not possible without explicit, preferably written policies. For example, to get rid of non-performing business rentals, asset managers need a mandate to privatize them, which should be established as a policy by the local council. The need for written policies brings up a whole host of challenges. First, there is no intrinsic culture at local governments to produce and implement written policies. Second, if such a policy is developed, what should be its legal status—should it be codified into a legally binding document (ordinance) or be a softer document? Third, in some cases it is not clear where to start—from policies or procedures.
6. *How much is “de-politization” of asset management feasible and desirable?* Is it feasible to reign in the influence of politics on asset management decisions by introducing a local Ordinance on Asset Management? If so, countries in transition might be a good place to try, as local governments there are still less swamped by layers of historically established ways of running the business of government than most developed countries.

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Notes

- ¹ According to G. Peterson (2006).
- ² According to O. Kaganova et al. (2001).
- ³ According to O. Kaganova, R. Nayyar-Stone, and G. Peterson (2000).
- ⁴ Very interesting examples of innocent but costly mistakes that can be caused by lack of professional expertise are provided by John Hentschel and Marilee Utter (2006) regarding the City of Baltimore (USA).
- ⁵ Those ex-socialist countries that have been admitted into the European Union.
- ⁶ For example, *All the King's Men* by Robert Penn Warren.
- ⁷ Draws upon F. Conway, O. Kaganova, and J. McKellar (2006) who generalized the reform experiences of Australia, Canada, France, and New Zealand.
- ⁸ This subject is discussed in the chapter from which the above reform framework is drawn.
- ⁹ Readers will easily recognize that all anti-corruption and efficiency-oriented approaches listed below in items A–F are fully compatible with the framework of good asset management suggested in Table 2. These approaches can be interpreted as specific justifications or technical solutions for the framework in Table 2.
- ¹⁰ A lot of corruption, favoritism, or conflict of interest happens through allocating public property to various users under “preferential conditions,” which often implies free-of-charge or below-market prices. Disclosure of information on conditions is essential.
- ¹¹ For example, comparison of prices obtained for municipal land sites sold through “direct sales” at estimated market prices and on auctions in one of Kyrgyzstan’s cities with a very active real estate market demonstrated that auction prices were, on average, at least 40 percent higher than “appraised” prices for similar sites.

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Finding the Money focuses on those areas of government most exposed to grand or petty corruption: budgeting, tax administration, public procurement, and management of government assets. The eight chapters collected in this volume are based on the assumption that corruption has systemic causes. By improving social accountability mechanisms and by increasing the institutional and human capacities of government, malfunctioning states and municipalities can be transformed. The anti-corruption techniques presented here go well beyond the introduction of political control mechanisms, expanding transparency, or revising the compact between the state and private service organizations to recommend the steps needed for fiscal transparency and good governance. Public sector integrity also depends on governments' capacity to introduce these measures, the incentives to comply set by intergovernmental fiscal relations, the use of audit and the shortest route of accountability, i.e., its direct influence by customers on service providers.

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