Budget Classification, and Program and Performance Budgeting

"Budget classification is one of the fundamental building blocks of a sound budget management system, as it determines the manner in which the budget is recorded, presented, and reported, and as such has a direct impact on the transparency and coherence of the budget."

- Davina Jacobs, Jean-Luc Hélis, and Dominique Bouley (IMF, 2009)

BUDGET CLASSIFICATION

This subunit deals with the basic requirements for expenditure classifications and the presentation of expenditures in the budget, which are essential elements in budget and policy formulation.

WAYS OF CLASSIFYING GOVERNMENT BUDGETS

Classifying expenditures is important for policy formulation and measuring the allocation of resources among sectors; ensuring compliance with the legislative authorizations; policy review and performance analysis; and day-to-day administration of the budget. An expenditure classification system provides a normative framework for both policy-making and accountability.

Expenditures may need to be classified in different ways for different purposes, such as:

- drafting reports that match the needs of report users (policy-makers, the public, budget managers);
- budget administration and budgetary accounting;
- budget presentation to the parliament.

Expenditures should also be reported according to the international standard classification, defined in the Government Finance Statistics (GFS). But the GFS focuses only on economic and functional reporting, while budget classification needs to be an instrument of policy formulation, budget administration and accounting.

Institutional classification

Institutional classification is country dependent and comprehensively covers all institutions of the general government. Institutional classification is defined with the System of National Accounts and European System of Accounts, which are basically the same with some exceptions.

Classification of institutional sectors (SNA, ESA)

The total economy of a country can be divided into sectors, with each sector consisting of a number of institutional units. The units in each sector have similar objectives and these objectives are, in turn, different from those of units in other sectors:

- the *non-financial corporations sector*, which consists of entities created for the purpose of producing goods and non-financial services for the market;

- the *financial corporations sector*, which consists of entities engaged in providing financial services for the market;

- the *general government sector*, which consists of entities that fulfil the functions of the government as their primary activity;

- the *household sector*, which consists of small groups of persons who share the same living accommodation, pool some or all of their income and wealth, and consume certain types of goods and services collectively;

- *non-profit institutions serving the household* sector, including all resident non-profit institutions, except those controlled and mainly financed by the government that provide non-market goods and services.

For analytic and other purposes each of these sectors may be divided into subsectors, and the subsectors can be combined in different ways to form other sectors. For example, the general government sector can be divided into the central government, the state, local governments and social security funds.

Classification of institutional sectors (SNA, ESA)

The public sector includes all units of the general government sector plus all public corporations. The general government sector consists of all government units and all non-market non-profit institutions that are controlled and mainly financed by government units.

Economic classification

An economic classification of expenditures is required for analyzing the budget and defining the macro-fiscal policy position. For example, the share of wages in government expenditure and the value of transfers to public enterprises are important measures of the impact of fiscal policy.

Functional classification

A 'functional' classification organizes government activities according to their purposes (e.g. education, social security, and housing). It is independent of the government's organizational structure. A functional classification is important to analyze the allocation of resources among sectors. A stable functional classification is required to produce historical surveys and analyses of government spending and to compare data from different fiscal years.

A functional classification allows broad analytical and statistical comparisons, particularly international comparisons.

Program classification

A program is a set of activities that meet the same set of specific objectives (e.g. development of crop production). In contrast to the Classification of Functions of Government (COFOG), a classification by program takes into account the government's policy objectives and how these policies will be implemented.

Classifying expenditures by program can serve two purposes:

- i identifying and clarifying objectives and policies;
- ii monitoring operational performance through performance indicators, which may relate to the inputs, outputs or outcomes of a particular program. A classification by program can contribute to improved transparency and accountability.

Source of funds classification

The classification of the expenditure by financing source presents public expenditure according to the type/origin of the resources used for financing. In other words, it defines expenditure according to the nature of revenues focused on the fulfilling of public needs. The importance of this classification lies in the relationship between resources and expenditure.

This was just a short overview of different budget classifications. Now proceed to read the IMF Technical Note on ***"Budget Classification"*** *written by Davina Jacobs, Jean-Luc Hélis, and Dominique Bouley.*

"Fiscal rules, medium-term budget frameworks, and risk management procedures facilitate achievement of the first two objectives – maintaining a sustainable fiscal position and effective allocation [...]. Performance budgeting (PB) also aims to contribute to effective allocations and to the third objective, efficient provision of public services. A different set of innovations centers on improving administrative management and the provision of public services. [...] More than a half a century of effort in many countries validates the conclusion that allocating resources on the basis of actual or expected results is a truly difficult task. [...] The space for improved performance is limited by impediments to reallocation, but in normal times almost all government budgets have some space. The aim of performance-oriented systems is both to expand this space and to ensure that it is put to productive use."

- Allen Schick (2013; Public Financial Management and Its Emerging Architecture)

PROGRAM BUDGETING

"Performance budgeting consists of classifying government transactions into functions and programs in relation to the government's policy goals and objectives; establishing performance indicators for each program or activity; and measuring the costs of these activities and the outputs delivered. The terms "performance budgeting" and "program budgeting" are often used interchangeably, but program budgeting can also be defined as a form of performance budgeting giving greater emphasis to the classification of programs according to the government's policy objectives and the needs of efficient resource allocation. A full system of performance budgeting is difficult to realize, in large part because of the high information requirements and complex management systems that are needed" (Allen and Tommasi 2001, 464).

Improving the level and quality of information on achievement of desired outcomes and the effectiveness of budget resource allocation is critical to ensuring that these resources are directed to programs where the benefits are highest. Monitoring of cost-effectiveness of government expenditures also helps reduce the costs of delivering specific government services and public goods. A performance-oriented budget is also important in maintaining long-term fiscal discipline as an outcome based performance measurements system contributes to the resource allocation decision process and can assist in targeting resources towards more productive and growth enhancing expenditure areas. It is also a valuable tool in making public finances more transparent and accountable by focusing on what is actually achieved through implementation of the government's expenditure programs.

"Performance budgeting should be viewed in the broader context of a set of **related "managing for results"** (MFR) reforms. MFR can be defined as the use of formal performance information to improve public sector efficiency and effectiveness. Its fundamental starting point is maximum clarity about the outcomes which government is attempting to achieve, and about the relationship of outputs, activities and resources used to those desired outcomes. Good strategic planning and business planning are an essential element of MFR. MFR also tends to emphasize the *ex-ante* stipulation of performance expectations for agencies, work units and individuals through the use of performance targets and standards. However, whereas the benefits are well understood, considerable uncertainty exists on how to design and implement a workable performance-oriented budget system" (Robinson 2011).

Box: Why performance budgeting?

- **Creates stronger links between allocated public resources and outputs/outcomes of the public sector**
- Impact on decisions in resource allocation by using performance information
- Produce and report relevant performance information

- **Assists three objectives of public expenditure management**
- Allocative efficiency by challenging the composition of public expenditure with respect to social needs and priorities
- Operational efficiency by encouraging cost-effective service delivery and value for money
- Aggregate fiscal discipline by affecting the level of public expenditure through allocative and operational efficiency

- **The logic is difficult to argue against**
- Many countries aspire to performance budgeting; implementation is a journey rather than a destination

Looking at the different countries practice, we can establish that there are various forms of performance budgeting. They differ from the weakest to the strongest form. One system may have all these, depending on the characteristics of the supply chain, the nature of the services being supplied, and the preferences and capabilities of the main players.

- **Weakest form**
  - Presentational performance budgeting
    - Instrument of transparency
- **Moderate form**
  - Performance informed budgeting
    - Instrument of accountability
    - Assists with efficiency
- **Strongest form**
  - Direct performance budgeting
    - An unambiguous contractual mechanism

How do we define program budgeting and how is it linked to performance

Program budgeting classifies expenditure by types of service and objectives, rather than—as in traditional budgeting—by types of inputs. Program budgeting is a powerful tool for performance-based budgeting because it indicates how much money is being directed at achieving particular outcomes. It enables budget decision makers to assess the benefits and efficiency of programs relative to their costs. **Program budgeting is, therefore, an element of performance-based budgeting.** Key goal is better expenditure prioritization. Spending is classified by objectives in this case program and not by input type. Budget process then uses these programs for expenditure priority decisions.

What is a program?

A program is a group of activities intended to contribute to a set of government objectives, specified in outcome terms. It is a coherent group of outputs aimed at a certain outcome; and it's also an essential element of program and performance budgeting.

As we said earlier, when spending is classified by programs and not by inputs, we have a different "type" of budgeting. Let us look visually at how they differentiate.

Figure: Line item budgeting vs. performance budgeting

Line item budgeting	Performance budgeting
Ministry of Environment	**Ministry of Environment**
Salaries 30 million EUR	Clean water 35 million EUR
Operational costs 10 million EUR	**Goal**: *Provide clean drinking water to 98 per cent of households by year 2020*
Investments 10 million EUR	Parks 15 million EUR
.	**Goal**: 75 per cent of citizens have access to the "green area" within 1 km of their home
.	.
.	.
	.

Every program needs to have:

- Identifiable target population/audience
- Defined budget
- Staffing and other resources
- Clearly defined outputs and outcomes

Note: Avoid describing program objectives in term of activities.

According to the "managing for results" theory as well as theory of change, each program should be clearly defined in terms of the following components: **inputs**, **activities**, **outputs**, **outcomes**, and **impact.** A table below provides a description of each of the components.

Table: Program components

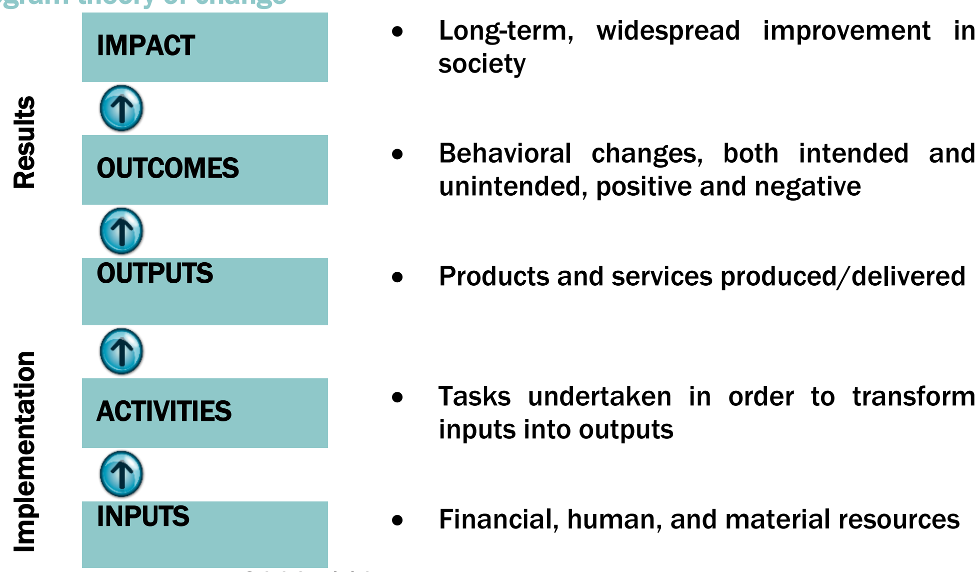
Component	Description
INPUTS	Resources that go into a project, program, or policy (funding, staffing, equipment, curriculum materials, and so forth).
ACTIVITIES	**What we do.** Activities can be stated with a verb ("market", "provide", "facilitate", "deliver").
OUTPUTS	**What we produce.** Outputs are tangible products or services produced as a result of the activities. They are usually expressed as nouns. They typically do not have modifiers. They are tangible and can be counted.

OUTCOMES	**Why we do it.** Outcomes are the behavioral changes that results from the program outputs. Outcomes can be increased, decreased, enhanced, improved, or maintained.
IMPACT	**Long-term changes** that result from an accumulation of outcomes. Can be similar to strategic objectives.

Source: Morra Imas and Rist (2009, p. 109).

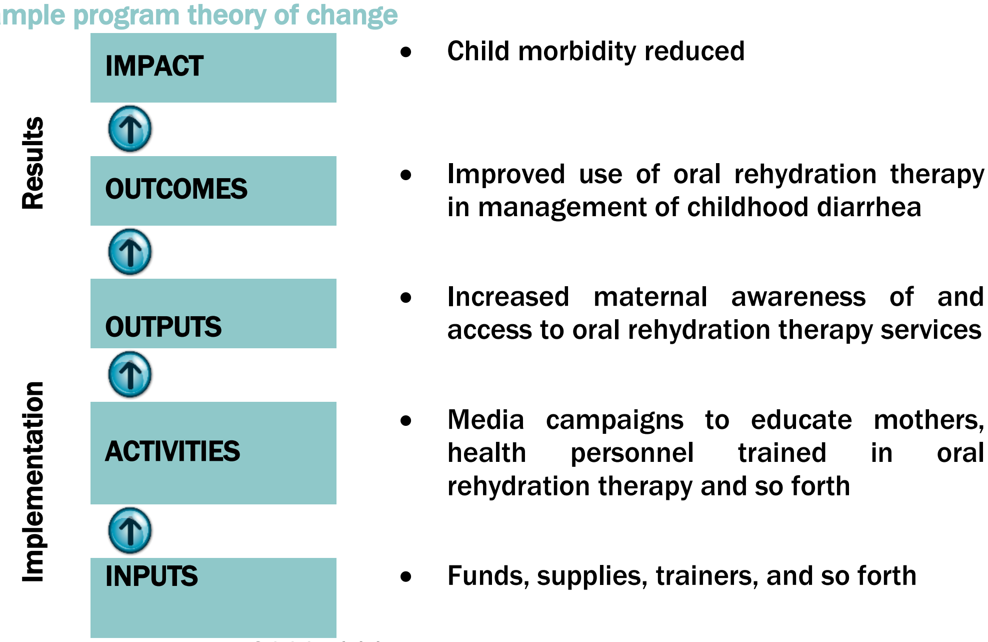
Based on the theory of change (theory of how initiative leads to desired results) we can depict the components graphically. We will do so first for the programs in generally, and then we will also show it through the concrete example.

Figure: Program theory of change



Source: Morra Imas and Rist (2009, 110).

Figure: Sample program theory of change



Source: Morra Imas and Rist (2009, 111).

In general, there are two different approaches to designing programs:

- Top-down approach
  - Start with impact but more often with outcome, and then roll back through results/theory of changes to inputs
  - In theory, this is an ideal approach
  - However, it can also be disruptive to some of the current activities
- Bottom-up approach
  - Start with inputs/activities
  - In practice, this is the most common approach.
  - But it can often lead to poorly defined outputs and outcomes.

Monitoring program implementation requires measurement of progress toward achieving outcome or impact. While outputs can be measured, outcomes often cannot be. Therefore, they must first be translated into a set of indicators that, when regularly measured, provide information about whether or not the outcomes or impact are being achieved. A performance indicator is a "variable that allows the verification of changes in the development intervention or shows results relative to what was planned" (OECD glossary).

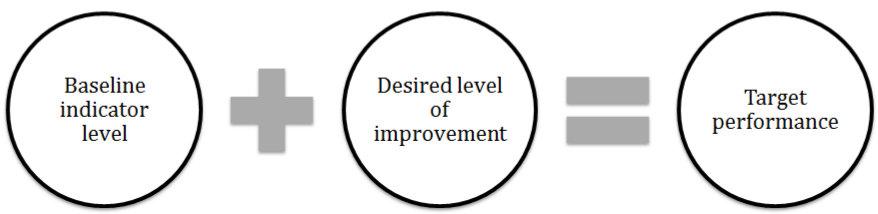
Developing indicators is a core activity in defining programs. Indicators should be "CREAM" (see Morra Imas and Rist 2009):

- Clear (precise and unambiguous)
- Relevant (appropriate to the subject at hand)
- Economic (available at reasonable cost)
- Adequate (able to provide sufficient basis to assess performance)
- Monitorable (amenable to independent validation).

Once indicators are agreed upon, it is important that targets are established.

Note: Only one target should be set for each indicator.

Figure: Performance targets



Source: Morra Imas and Rist (2009, 122).

Frequently, in national budgets, programs are structured into programs, subprograms, and activities. Subprograms (which are usually outputs rather than outcomes) pursue the same policy objective as the program to which they belong but do this by either producing slightly different outputs or producing similar outputs in different ways. However, it must be said that individual countries pursue different models for their program structures.

➔ **Programs**
➔ **Subprograms**
➔ **Activities**

Figure: Example of the program structure

Programs

1. Strengthening rural areas
2. Nature realization
3. Nature maintenance
4. Economically viable agriculture
5. Promoting sustainable production

    Subprograms

    5.1. Promoting organic farming
    5.2. Decreasing use of chemical fertilizers
    5.3. Protection of crop safety
    5.4. Improved animal welfare
    5.5. Eco-friendly fishing

        Activities

        5.5.1. International coordination
        5.5.2. Improvement of domestic fishing
        5.5.3. Innovation projects
        5.5.4. Technical measures and research
        5.5.5. Various

    5.6. Administration
6. Food safety, quality and animal health
7. Research and development
8. ...

Implementation process of performance budgeting

In principle, the implementation process of performance budgeting involves the following steps:

- Establishing a budget classification structure to include details on programs and sub-programs as well as more traditional economic, functional and organizational classification codes;
- Aligning the budget classification and the chart of accounts;
- Defining objectives (outputs and outcomes) for the different programs and sub-programs;
- Aligning inputs and activities within programs and sub-programs to contribute to the stated objectives;
- Defining indicators for inputs, activities, outcomes, and outputs;
- Defining combinations of indicators to estimate performance (effectiveness, efficiency and economy);
- Using performance indicators to inform budget decisions.

The **Chart of Accounts** is a critical element of the PFM framework for classifying, recording and reporting information on financial plans, transactions and events in a systematic and consistent way. The COA is an organized and coded listing of all the individual accounts that are used to record transactions and make up the ledger system (IMF, 2011).

To learn more about the Chart of Accounts, read the IMF Technical Note on "Chart of Accounts: A Critical Element of the Public Financial Management Framework" (TNM/11/03).

While the process appears relatively straightforward, most countries have encountered significant difficulties in attempting to implement a performance orientated budget system and have found that it can take many years to move through the different steps. Many OECD countries that established program classification structures in the late 1960s or early 1970s have only recently reached the last stages of the process, and others have not even reached these stages. Not surprisingly, efforts to introduce performance-oriented budgeting in transition and developing countries have encountered even greater difficulties.

To implement an effective performance oriented budgeting system, budget units need to have considerable flexibility and management to determine how to manage their budgetary resources in order to meet their agreed objectives and targets. Increased responsibility must also include increased accountability. Improving management capacity, financial reporting and ex-post internal and external control functions are also essential elements of the introduction of performance budgeting. Traditional ex-ante controls over inputs, while remaining important, are largely devolved to budget units with central oversight focused on ex-post internal and external controls emphasizing reviews of activities carried out and results achieved. Devolution of responsibility and accountability to budgetary units necessarily needs to be contingent on capacity and controls being in place.

Many emerging economies have found it difficult to instill a culture of managerial accountability at the point of service delivery (i.e. in operation government units) which has made the introduction of performance budgeting difficult to achieve. If managers do not have control over their budgeted inputs and are not made accountable for delivery of their outputs/outcomes, it is hard to impose meaningful performance targets

The recent studies on performance budgeting show that performance budgeting as a management tool of public administration can be enhanced with the introductions of several "changes" (see IMF PFM blog post on March 7, 2012: http://blog-pfm.imf.org/pfmblog/). These include the following:

- It should be integrated with strategic thinking at the government level;
- Strong ties need to be created between the MoF and the main coordinating body, responsible for strategic planning;
- Strong political support is needed for performance budgeting reforms to work;
- Civil society needs to become more interested in the debates surrounding the introduction and implementation of performance budgeting.

*Now proceed to read Chapter 7 of the IMF publication "Public Financial Management and Its Emerging Architecture" on **"In Search of Results: Strengthening Public Sector Performance".***

*Then continue to read the IMF Technical Note on **"A Basic Model of Performance-Based Budgeting"** written by Marc Robinson, and Duncan Last.*

BIBLIOGRAPHY

Asian Development Bank (ADB). Promoting Results-Based Management in the Public Sectors of Developing Countries. *The Governance Brief*, Issue 4. Manila: The Asian Development Bank.

Allen, Richard and Daniel Tommasi, eds. 2001. *Managing Public Expenditure: A Reference Book for Transition Countries*. Paris: OECD Publications.

Crain, M.W, and J. Brian O'Roark, 2004, "The Impact of Performance-Based Budgeting on State Fiscal Performance," *Economics of Governance*, Vol. 5, No. 2, pp. 167–186.

Curristine, Teresa. 2007. Experience of OECD Countries with Performance Budgeting. In Marc Robinson (ed.), *Performance Budgeting: Linking Funding and Results*. Washington: International Monetary Fund.

Morra Imas, Linda G. and Ray C. Rist. 2009. *The Road to Results: Designing and Conducting Effective Development Evaluations*. Washington: The World Bank.

OECD. 2007. *Performance Budgeting in OECD Countries*. Paris: OECD.

Olander, Sven. 2007. Public Finance Management in Development Co-operation. *A Handbook for Sida Staff*. Sida.

Pogačar, Bojan. 2010. Budget and the Institutional Context. Paper presented at the Center of Excellence in Finance Introduction to Public Financial Management Summer School in Ljubljana Slovenia.

Robinson, Marc, and Jim Brumby. 2005. Does Performance Budgeting Work? An Analytical Review of the Empirical Literature. *IMF Working Paper* 05/210. Washington: International Monetary Fund.

Robinson, Marc. 2011. *Performance-Based Budgeting: Manual*. Washington: The CLEAR Initiative.

Shah, Anwar, ed. 2007. *Budgeting and Budgetary Institutions*. Washington: The World Bank.