

Introduction

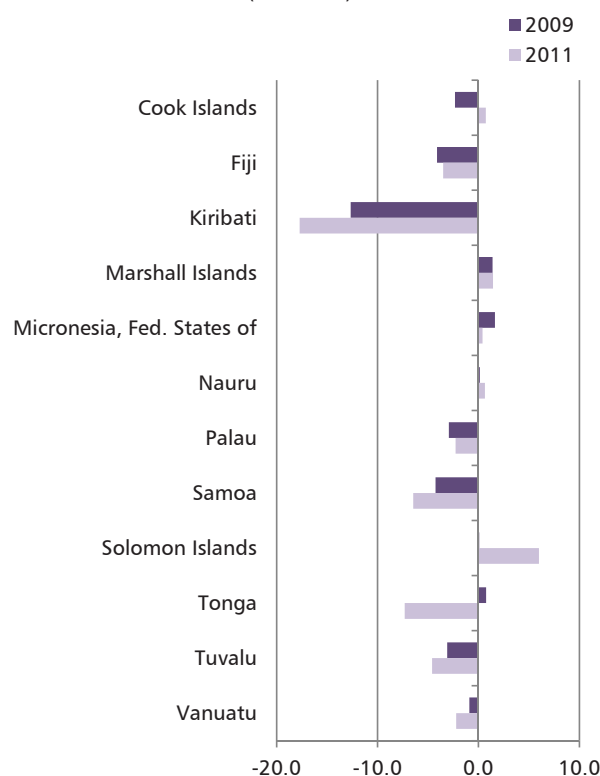
The global economic crisis placed severe strain on the budgets of many of ADB's Pacific developing member countries (DMCs). Different countries were affected in different ways. In Tonga and Samoa inward remittances fell sharply, depressing the level of economic activity; in Fiji and the Cook Islands, tourism declined; in Kiribati and Tuvalu, the global fall in equity prices led to a sharp decline in trust fund revenues; and, in Solomon Islands and Nauru, demand and export prices for the main commodity exports of timber and phosphates fell as global demand contracted. By early 2009, with the exceptions of Timor-Leste, Tonga, and Vanuatu, the Pacific DMCs were recording large, negative fiscal balances, as shown in Figure 1.¹ Economic activity in these countries had largely recovered by 2011, but many countries were, by then, running persistent and unsustainable budget deficits that deeply concerned policy makers. A key challenge now is for governments to more effectively manage public expenditure and consolidate and restore fiscal balances, while formulating appropriate policy responses to help economic recovery.

ADB has provided assistance with budget management to a number of Pacific DMCs over many years. This policy brief examines the recent experience of the Cook Islands, Kiribati, and Tonga with budget management reform, including elements of broader public financial management which impact on budget management such as procurement and external auditing, in order to draw lessons on how the quality and efficiency of overall public spending in the Pacific could be improved.

Challenges to Good Budget Management in the Pacific

Pacific DMCs face numerous challenges in managing public spending. Some of these are related to features common to many of the smaller developing economies including distance from major markets, narrowly based economic activity, large informal sectors, large skill gaps, and aid dependence. Others relate to factors such as political and macroeconomic instability, which hinder investment and stifle economic growth. Taken together, these factors weaken the capacity of countries to plan and spend their finances effectively and to make use of sophisticated budget management processes. They often result in budgets that bear little relation to government plans and policies, budget execution that differs significantly from what is actually in the budget, incomplete control mechanisms, and serious delays in budgetary reporting.

Figure 1: Estimated Fiscal Balance of Selected Pacific DMCs, 2009 and 2011
(% of GDP)



Source: ADB.

Figure 2 highlights the economic and structural characteristics of the Pacific DMCs and typical fiscal outcomes facing them. The key challenge for most Pacific DMCs is to steadily improve budget management practices to improve public service delivery. Given the extent of the challenges facing many of the Pacific DMCs, the process of transforming budget management is, of necessity, gradual, and progress incremental. Nevertheless, solid advances have been made in recent years—as illustrated by the experience of the Cook Islands, Kiribati, and Tonga.

Building Budget Management Capacity

ADB has provided significant financial and technical support to Pacific DMCs to help improve their budget management practices and capabilities. The starting point for this work has been an accurate identification of gaps and weaknesses in budget management capacity using the Public Expenditure and Financial Accountability (PEFA) Assessment Framework.² The PEFA assessment is a widely used approach to benchmarking budget management practices against generally recognized good principles and practices.

Using the PEFA Assessment Framework, the budget cycle is analyzed with respect to (i) policy-based budgeting; (ii) predictability and control in budget execution; (iii) accounting, recording, and reporting; and (iv) external scrutiny and audit. Drawing on the results of country-level PEFA assessments, ADB has provided regional and country technical assistance (TA) to support the Cook Islands, Kiribati, and Tonga with reforming their budget management practices.³ This support has been designed to guide the Pacific DMCs through a carefully sequenced and prioritized series of incremental reforming steps, while at the same time building institutional capacity to sustain the resulting budget management improvements in the years to come.

Broadly speaking, the reform process can be broken down into three components—the reforming of budget preparation; the effective linking together of policies, planning, and budgeting; and budget implementation and monitoring. These are discussed in the following three sections.

Reforming Budget Preparation

Budget preparation is, by definition, the first step in the budget management cycle. The preparation normally begins with a strategic process involving a review of past economic and financial performance by the budget agency. This is done to provide a foundation for establishing a fiscal framework in which policy choices and spending priorities can be set.

In the Cook Islands, budget preparation regulations and processes are relatively well defined. The Ministry of Finance and Economic Management (MFEM) Act of 1996 specifies the budget formulation process in great detail. It also identifies the fiscal aggregates that the government must use and specifies the information that must be made public and that which must be presented to the Parliament. The Act requires the government to keep operating expenses within the limits of the government's internal revenues and to publish statements of its multi-year economic and fiscal strategy in advance of the annual budget.

The Cook Islands PEFA Report of October 2011 found that recent reforms were heavily focused on improving the fiscal framework and were broadly successful in strengthening public sector financial processes. Other important reforms included the development of a medium-term budgeting framework and the commitment of the government to manage total Crown debt⁴ at prudent levels; manage prudently its fiscal risks; and regularly update financial ratios for capital expenditure and maintenance, personnel costs, and other operating costs.

A noteworthy feature of the Cook Islands budget preparation processes is public dissemination of fiscal information. In October 2011, the MFEM published the 2012–2013 Budget Consultation Report Document, which laid out the economic and financial profile of the country and reported on the outcomes of the country's 2011 Economic Summit.

In Kiribati, a PEFA assessment was prepared in 2010. It identified numerous weaknesses in budget management and attributed these primarily to institutional capacity constraints. In response to the PEFA report, the government committed domestic and development partner resources to strengthening budget management through the design of an overarching public financial management reform plan. This was prepared together with a medium-term fiscal framework, which was designed to inform the preparation of the 2011 national budget and future budgets. A budget team was then constituted, its members drawn from the various units of the Ministry of

Figure 2: General Challenges for Budget Management in the Pacific



Source: Schick, Allen. 1998. *A Contemporary Approach to Public Expenditure Management*. Washington, DC: World Bank.

2 PEFA Secretariat. 2005. *Public Financial Management—Performance Measurement Framework*. Washington, DC: World Bank.

3 ADB. 2009. *Pacific Economic Management TA Report*. Manila: ADB.

4 Central government debt, that is, the stock of direct liabilities in the form of loans, most of which is externally borrowed. Government guaranteed debt is excluded.

Finance and Economic Development (MFED). ADB advisors subsequently cooperated with the team on preparing a reform plan and undertaking policy analysis to inform the preparation of the 2011 budget.

A PEFA assessment was also prepared for Tonga in 2010. It concluded that the annual budget formulation process was reasonably well developed and that the line ministries were provided with sufficient guidance and time to prepare and discuss spending proposals with the central agencies. The first steps toward the development of a multi-year budgeting system commenced in 2010 with the support of experts provided by ADB.

Strong cross-government communication and coordination is essential to generating a budget that is coherent and consistent across the different arms of government. With this in mind, in 2011 the Tongan government acted to strengthen its budget preparation processes by re-activating a number of cross-government policy committees. The Macroeconomic Technical Committee held more regular meetings in order to monitor macroeconomic developments and to prepare consolidated economic and financial projections. Furthermore, the Ministry of Finance and National Planning convened a regular forum for heads of departments to discuss economic policy issues. The work of these various committees was critical in generating the policy parameters and fiscal projections that served as building blocks for the medium term budget framework.

Linking Policy, Planning, and Budgeting

Different approaches have been adopted in the Cook Islands, Kiribati, and Tonga to strengthen the links between policy, planning, and budgeting. The Cook Islands held an Economic Summit to facilitate consultations on public policy choices which then served to directly inform the preparation of the

next budget. In Kiribati, a new recurrent budget format has been adopted which provides clearer links between ministry, sector, and national development plans. In Tonga, emphasis has been placed on strengthening the links between the national development plan, ministry corporate plans, and annual budget priorities. Tonga has focused on ensuring that the corporate plans and budgets of the ministries and departments reflect its national development priorities. Measures taken to strengthen the links between policy, planning, and budgeting are described in more detail in the box below.

Box: The Kiribati Experience—Improving the Planning-Budget Link

In 2007, the Government of Kiribati initiated a comprehensive public sector financial management reform program. Development partners, including ADB, the World Bank, and IMF-PFTAC, provided strong support to Kiribati for the implementation of a medium-term fiscal framework. In addition, new recurrent budget formats were adopted. These ensure that priority is accorded to funding programs and activities that have a clear and measurable link to annual ministry operational plans, sector plans (where available), and the Kiribati Development Plan.

An expert from the ADB Pacific Economic Management Technical Assistance provided support in 2010 when workshops were held to cover the general concepts and principles of budgeting, the budget cycle, and the links between the budget and the various development plans. The advisor also helped to develop a new format for the presentation of the budget. The workshops were conducted by MFED officials in the Kiribati language with support from external experts.



ADB has provided assistance with budget management to a number of Pacific DMCs over many years including regional capacity building workshops. "Improved fiscal management will help ensure scarce fiscal resources are used efficiently and policy makers, with clearer understanding of the fiscal implications of their policy decisions, can make better choices about allocating the limited resources they have available," said Adrian Ruthenberg, Regional Director, ADB Pacific Subregional Office at the Fiscal Management Model workshop (December 2012)



Roru Poturu and her grandson rely on water from a public tank which was repaired using ADB funds from the Cook Islands Cyclone Emergency Assistance Project. Facilitating consultations on public policy choices, which then serve to directly inform the preparation of the next budget, could help governments plan ahead and set aside funds in times of emergencies

Budget Implementation

Budgets are only effective as tools of public sector financial management i) if they are implemented as planned; ii) if spending is carefully controlled and delivers value-for-money; and iii) if budget performance is tracked, reported on, accounted for, and audited in a timely manner. Figure 4 summarizes budget implementation processes based on the most recent PEFA reports for the three Pacific DMCs. In all three countries, budget control tended to depend on the rationing of cash, rather than on the use of systematic cash flow forecasts. In terms of spending, there was a pronounced tendency for capital outlays and social expenditures to diverge from what had been planned.

There were also a number of country-specific budget implementation challenges. The PEFA report for the Cook Islands, for example, noted that budget execution suffered from a tendency to overshoot fiscal targets. It proved difficult to compare actual expenditures with what was budgeted because of delays and other weaknesses in the government accounts, and the use of different time bases for reporting variations. At the same time, aggregate fiscal discipline was satisfactory with no difficulties with cash flow or significant expenditure arrears, which hid the extent of variation.

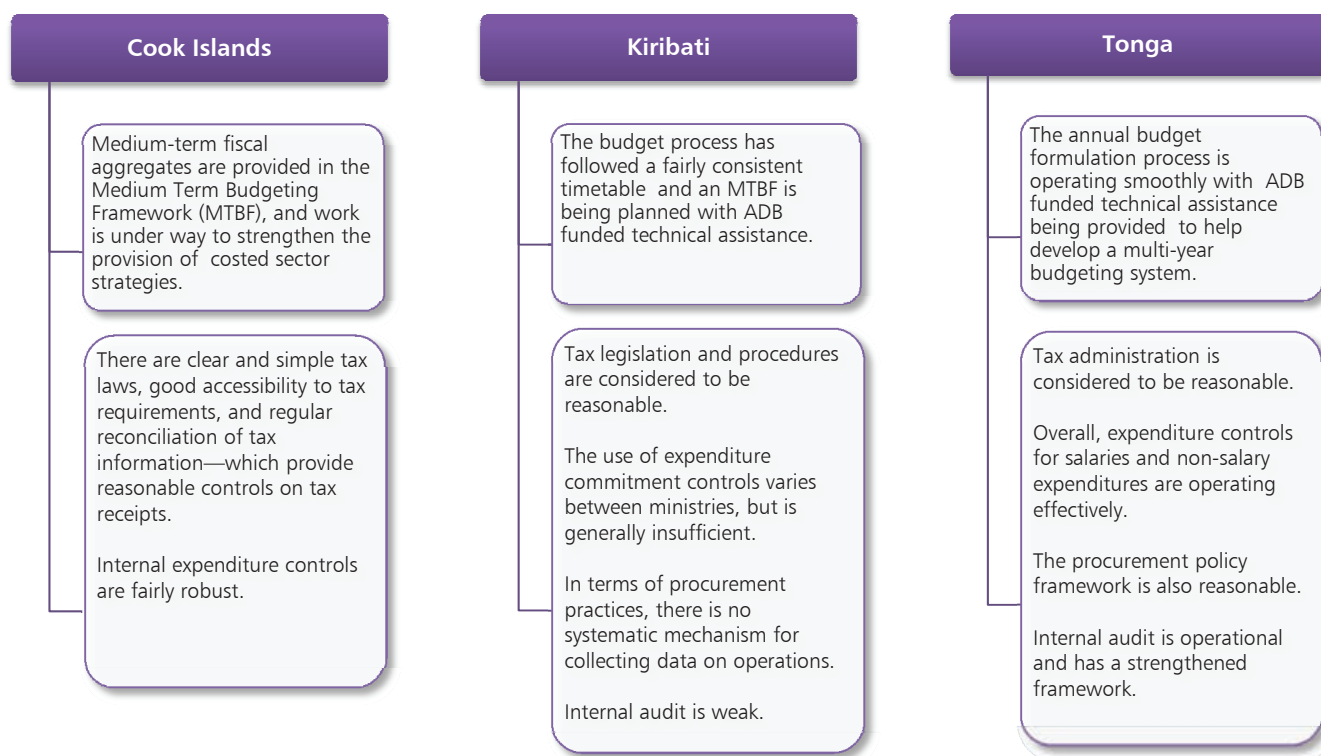
In Kiribati, the PEFA report noted that, for the period 2006–2008, the budget appeared to have been a reasonably credible indicator of actual expenditure. However, the report urged caution in interpreting this conclusion because the quality and completeness of the financial statements needed

further improvement. The stock of expenditure payment arrears was not known, arrears were not monitored, and advances had not been routinely retired.

In Tonga, the PEFA Report concluded that while recurrent expenditure controls were reasonably effective, there was still room for improvement with regard to accounting, reporting and recording of public spending. In particular, the report drew attention to delays in clearing suspense accounts, the need for more timely submission of financial statements (which are often a year or two overdue), and the inadequate nature of information on commitments in budget reports.

Budget implementation in the Cook Islands, Kiribati, and Tonga has improved in recent years with support from ADB and other development partners to strengthen financial controls. This effort has already started to pay off—all three countries have maintained budget outturns close to the approved budget. Institutional capacity to improve budget execution is also steadily improving. The Cook Islands, for example, has adopted a medium-term budget framework, while both Kiribati and Tonga have committed to adopting such a framework in the near future. In Tonga, the government issued new Treasury Instructions in 2010 and has issued new procurement procedures that are aligned with international standards. Training in expenditure management is being undertaken with ADB TA support to improve the financial management information system in all three countries. Support has also been provided to ensure regular reporting of public debt status, monthly bank

Figure 3: Budget Implementation Assessments of the Cook Islands, Kiribati, and Tonga



Note: This figure was extracted from the PEFA Assessments for the Cook Islands (2011), Kiribati (2010), and Tonga (2010).

reconciliations, regular cash flow management reports and advice to management, daily cash position reviews (against daily budget ceilings for line ministries), and improved recording of development partner-assisted projects. Better financial management is designed to provide the fiscal authorities with the information needed to take corrective action in a timely manner, while improving the capacity for fiscal forecasting and expenditure analysis.

First Things First: Building Good Budget Management Practices

Managing the budget effectively and efficiently in Pacific DMCs is a challenging undertaking. Hampered by severe skill shortages and institutional constraints, buffeted by volatile revenues and uncertain donor inflows, and faced with spending requirements that inevitably exceed available resources, the preparation and implementation of a budget can be an arduous task. Experience in the Cook Islands, Kiribati, and Tonga points to a number of deficiencies in the budget process, but also demonstrates that meaningful improvements are possible. The most important lesson from this experience is the need to focus on getting the budget basics right—in a highly constrained development setting, Pacific DMCs should start by ensuring that the basic building blocks of a sound budget management process are in place. This requires that the following steps are taken:

- **Ensure stakeholders buy-in:** Building public awareness is essential to ensure that stakeholders agree to medium-term budget objectives and targets, particularly in close-knit



The key challenge for most Pacific DMCs is to steadily improve budget management practices so as to contribute to more effective, efficient, and sustainable public service delivery, not just for this generation but also for the next one too



Political commitment and leadership are crucial to successfully addressing budget management challenges. Parliament of Kiribati, Maneaba ni Maungatabu



There is a need to ensure that core staff and essential computer facilities are in place in order to make possible efficient budget preparation and execution

societies with strong reciprocal obligations. The National Economic Summit in the Cook Islands in 2011 is a good example of how to build broad-based ownership of medium-term budget priorities.

- **Update financial legislation:** Financial legislation must be periodically updated to remain in line with internationally accepted standards of good budget practice. The updating of procurement legislation in Tonga in 2010 is an example of this.
- **Make available core staff and essential computer facilities:** There is a need to ensure that core staff and essential computer facilities are in place in order to make possible efficient budget preparation and execution. Capacity constraints (such as lack of skilled staff, high staff turnover, and outmoded computer systems) have adversely affected governments' ability to provide a wide range of budget management functions. Training, staff development, judicious use of foreign advisors, and other capacity development measures must be an integral part of developing a robust budget management system.
- **Begin with strong financial controls:** Strong financial controls over expenditure inputs (i.e., staff, materials, capital goods) are essential if budget agencies are to ensure that budgets are prepared in a consistent and coherent manner.
- **Develop a reliable accounting system:** Accounting systems must be reliable if the government is to track spending and relate spending to the services it wishes to deliver.
- **Build an effective auditing system:** Good auditing systems help foster trust in the budget process. Ensuring that audit

reports are produced in a timely manner and that their recommendations are acted upon can reinforce confidence in the integrity of the budget process.

- **Adopt and implement predictable budgets:** Budgets should be predictable. Throughout the preparation process, they should be based on transparent processes in which stakeholders have been closely consulted.
- **Establish an effective organizational structure:** Budgets are prepared within an organizational framework. Reforms which clarify institutional responsibilities and which foster clearer cross-agency communication and cooperation can lead to vastly improved budget outcomes. Simple measures aimed at improving organizational arrangements for preparing and implementing budgets can have a powerful impact. For example, in Kiribati, workshops on the medium-term expenditure

framework, undertaken in the local language, and led by MFED, contributed to building awareness and improved understanding among the line agencies. The Government of Tonga's efforts to reactivate its macroeconomic technical committees in 2011 made an important contribution to generating the consistent and coherent macroeconomic and fiscal projections which were essential to the underpinning of its medium-term budget framework exercise.

Reforming Budget Processes: Lessons That Can Be Drawn

The challenges faced by the Cook Islands, Kiribati, and Tonga in relation to budget management are not unique in the region. The key lessons from ADB's experience in assisting in the budget reform process of these three countries include:

LESSON 1: Secure political commitment

Political commitment and leadership are crucial to successfully addressing budget management challenges. In all three Pacific DMCs, ownership at the highest levels was essential to driving the reform process. It was also essential to "opening up" the budget consultation process to key community-level stakeholders. This played a valuable role in building widespread understanding that the budget needed to be reformed and that the budget should reflect the social and economic policy choices of the society. This combination of strong top-level leadership and bottom-up support from the communities provided powerful incentives for cross-government cooperation in budget reforms that were difficult to implement, particularly when reforms such as civil service downsizing were required. Strong political commitment to effective budgets, greater transparency and stakeholder engagement can make a valuable contribution to economic dynamism and sustainability.

LESSON 2: Start with low-cost reforms

Measures to strengthen budget management do not need to be resource intensive. Ensuring that there are clear lines of accountability has been found to result in considerable improvements in budget effectiveness if coordination and cohesion in decision making are reinforced. Such changes do not require significant outlays of funds or personnel. In Tonga, a review of the budget preparation process identified bottlenecks in the various communication and decision-making channels and weaknesses in existing organizational arrangements. This aspect of the PEFA assessment provided a good understanding of where low-cost improvements could be made to render the preparation of successive budgets more efficient and effective.

LESSON 3: Strengthen what is already there

Much can often be gained from reinforcing existing budget management tools and procedures. Sometimes budget management processes and procedures have been adopted without a clear understanding of why they are in place or how they can best be used. For example, the acquisition of budgeting software by Pacific DMCs has not always resulted in enhanced expenditure effectiveness as only a part of the available software capabilities are used. Making modest adjustments to existing processes or tools could yield significant benefits in terms of improved communication, quicker decision making and more rigorous analysis.

LESSON 4: Be mindful of widespread capacity constraints

Capacity constraints are a fact of life in the Pacific DMCs, including in the Cook Islands, Kiribati, and Tonga. The measures taken by the governments of these three countries to overcome such constraints through regular staff training and the judicious use of external experts provide a key lesson from which other Pacific DMCs can learn. It is essential that governments take the lead in addressing the challenge of capacity constraints in order to ensure that budget reforms can be sustained.



Tufui Faletau of the Policy and Planning Division, Ministry of Finance, outside Treasury Building, Nukualofa, Tonga. Tonga has emphasized strengthening the links between the national development plan, corporate plans, and annual budget priorities

Reforming budget management is, everywhere, a long-term process. The Pacific DMCs face many constraints that will need to be tackled as they attempt to restore their budget management systems. Nonetheless, the reforms that have contributed to improvements in budget management in the Cook Islands, Kiribati, and Tonga provide examples that policy makers of other Pacific DMCs can consider to support their own efforts at fostering more effective and efficient use of scarce public resources.



The global economic crisis placed severe strain on the budgets of many Pacific DMCs. In Tonga and Samoa, inward remittances fell sharply, depressing the level of economic activity

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