CONCEPT NOTE

PEM PAL 2011 BCoP Event
REFORMS TO CAPITAL BUDGETING PRACTICES
June 14-17, 2011
Minsk, Belarus

Background

PEM PAL, the Public Expenditure Management Peer-Assisted Learning network, launched in 2006 with the help of the World Bank, aims to support reforms in public expenditure and financial management in twenty one countries in Europe and Central Asia by promoting capacity building and exchange of information.

PEM PAL brings together high level practitioners organized around three Communities of Practice (CoPs) for budget, treasury, and internal audit. All three CoPs meet periodically to share experiences among themselves and to seek practical solutions for priority issues related to public financial management reform implementation.

Individually, the CoPs also hold events to discuss reforms for certain aspects of their work related to their community of expertise. As part of the Budget CoP's learning agenda, it has events and study visits planned over the coming year on capital budgeting, fiscal rules and budget management information systems.

The event proposed for June 14-17, 2011 in Minsk, Belarus will examine the capital budgeting practices in a number of countries at different stages of reform implementation with a view to determining better practices that could be implemented within the PEM PAL member countries.

Rationale

Public capital investment can potentially contribute to a country's economic growth and the achievement of its development objectives. Effective processes for capital planning, capital budget formulation and capital budget execution are essential elements for ensuring a country's social and economic development and its financial stability. Without a systematic plan for acquisition, construction, and development of capital assets, countries will not be able to provide essential services to their citizens and business community.

Governments may define 'capital' in different ways. However it generally refers to physical assets with a useful life of more than one year. However, it also includes capital improvements or the rehabilitation of physical assets that enhance or extend the useful life of the asset. This is distinct from repair or maintenance which only assures the asset is functional for its planned life (Jacobs, 2009, p.3).[1]

Experience shows that without a properly organized capital budget, assets are inadequately maintained, major projects suffer from poor management and performance, and governments resort to borrowing without considering fiscal sustainability. Defining an appropriate balance between recurrent and capital expenditures also remains a key challenge in government

[1] Capital expenditure has a clear and universal definition in the national acccounting system and economic classification of government expenditures. For more information see IMF, Government Financial Statistics Manual, 2001, European System of Accounts, and the United Nations' System of National Accounts.

budgeting. Further, budgeting for government investment continues to be not well integrated into the formal budget preparation process in many countries (Jacobs, July 2008).

Countries commonly adopt special processes for addressing capital or investment spending. However, despite the need for special treatment of capital assets to ensure their effective management, considering capital spending separately from overall budget, accounting and reporting processes can lead to poor planning and information sharing across different processes. This is often referred to as dual budgeting[2] and does not provide for comprehensive analyses of all government revenues and expenditures or the evaluation of their outcomes and results. This increases the risk of capital projects that lack the recurrent funds to maintain or run them eg schools with no teachers, hospitals with no equipment, poorly maintained government facilities.

Thus, current research and experience dictates that the capital budgeting process must be fully integrated into a government's medium term budgeting and financial management process and capital spending needs to be considered within the context of government-wide and sector-specific multi-year strategies and objectives (Dorotinsky, 2008).

The World Bank's *Public Expenditure Management Handbook* describes the separation of recurrent and development budgets[3] as the most important culprit in the failure to link planning, policy, and budgeting, and in poor budgetary outcomes. The International Monetary Fund[4] also warns that dual budgeting systems may be based on inconsistent macroeconomic assumptions, budget classifications and accounting rules.

Experience has also shown that when the preparation and execution of the recurrent and development budgets are institutionally, organizationally, and technically separate, real coordination between the two is very difficult. The separation of processes can occur along many dimensions:

- Separate planning and budget allocation processes
- Separate central ministries (or areas within the one ministry) managing processes and making different decisions
- Separate budget documentation processes
- Separate budget execution, accounting, banking and reporting processes

(Sarraf, 2005)

Most OECD countries have achieved a high degree of integration of their recurrent and capital budgets. In some countries (eg New Zealand, United Kingdom, Norway), highly sophisticated strategies for managing the government's stock of capital assets and new investment programs have been developed. Efforts to extend the time horizon for investment planning have also included the introduction of medium-term budget frameworks (MTBFs). The majority of OECD countries now prepare comprehensive MTBFs although this type of reform has proven to be conceptually and practically very demanding. In particular, line ministries have found it difficult to develop credible, multi-year budget estimates (Jacobs, 2008).

For low-income countries, there has been limited progress in the integration of recurrent and capital budgets, with institutional incentives and donor funding and practices tending to

[2] Dual budgeting is budgeting separately for recurrent and capital expenditures.
[3] A development budget generally consists of externally financed capital (and increasingly recurrent expenditures); plus expenditures financed from government counterpart funds (recurrent or capital); plus the government's own-financed capital expenditures (Sarraf, 2005, p2).
[4] Guidelines for Public Expenditure Management, IMF, 1999 as referenced in Sarraf, 2005

reinforce the maintenance of separate processes.[5] Recurrent costs of capital projects continue to be ignored in these countries due in part to the lack of coordination between the two separate budgets. Further, the failure to ensure resources are available for ongoing maintenance of capital investments also provides incentives to seek extrabudgetary revenues such as road funds. Weak budgetary incentives also can encourage ministries to pursue activities that should be classified as recurrent, through the development budget (Jacobs, 2009).

Objectives

The objectives of the BCoP 'Reforms to Capital Budgeting Practices' event are to:

- review capital budgeting practices in PEM PAL member countries and to discuss options on how to improve them;
- identify key benchmarks for effective capital budget planning, prioritization and implementation;
- discuss obstacles in capital budgeting reforms and potential options to remove them.
- disseminate information on good practices and participate in discussions on how to apply those practices within PEM PAL member countries.

Outputs

Participants will learn:

- Good practices in capital budgeting (eg through country examples, distribution of guidelines and other information).
- The key steps in the capital budgeting cycle covering planning, budget, implementation and audit and the key benchmarks for effective capital budget planning, prioritization and implementation.
- Current practices in capital budgeting within PEM PAL member countries.
- Identification of main obstacles to reform and how to address them.

Participants

It is envisaged that this event will bring together up to 50 participants including BCoP members and external experts.

Format

The format will be a participant driven event over 3.5 days, including a group tour hosted by the MoF Belarus. Simultaneous translation in English/Russian/Bosnian will be provided at all sessions. At the end of the event, a BCoP Executive Committee meeting will be held to discuss future planned activities, evaluate the work done, and to vote on nominations for potential additional candidates to join the BCoP Executive Committee.

The event will comprise a mix of:

- **Analysis** of current status and progress of capital budgeting reforms in PEM PAL member countries (conducted through a pre-event survey with results presented at the event);
- **Information** and **presentations** on PEM PAL and other country approaches; and
- **Facilitated discussions** (to discuss PEM PAL country approaches, survey results and distributed information).

[5] With the Paris Declaration and Accra Agenda, these practices are changing with donors increasingly using budget support and multilateral instruments to provide aid.

Partners
The BCoP Capital Budgeting Event is being organized in collaboration with a number of key partners, including the World Bank, Belarus Ministry of Finance, and Ministry of Finance of the Russian Federation, SIGMA/OECD, InWent, SECO and the Center of Excellence in Finance acting as a PEM PAL Secretariat.

Contact
Bojana Crnadak
PEM PAL Secretariat - Center of Excellence in Finance
Cankarjeva 18
1000 Ljubljana
Slovenia/Europe
Phone: +386 1 369 6333
Fax: +386 1 369 6242
E-mail: bojana.crnadak@cef-see.org

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