Fiscal Affairs Department

# Budget Classification

## PEMPAL Workshop Presentation, October 12, 2010


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# Sources

- **Main source: IMF Fiscal Affairs Department Technical Note *Budget Classification***
- **Other important sources:**
  - **IMF *Manual on Fiscal Transparency (2007)***
  - **IMF *Government Finance Statistics Manual 2001***
  - **OECD *Managing Public Expenditure. A Reference Book for Transition Countries***
  - ***Treasury Reference Model***
  - **IMF Fiscal Affairs Department Technical Note *Transition to Accrual Accounting***

# Outline

- Presentation assumes budget is on a cash basis
- Importance of budget classification
- Main features of sound budget classification
- Desirable budget classification structure
- Relationship between budget classification and the chart of accounts (COA)
- Preconditions for successful implementation
- Critical steps in reform of budget classification

# Importance of Budget Classification 1

- Fundamental building block of budget management system
- Determines how budget is presented, controlled and reported
- Crucial for transparency and understanding of budget, and public finances in general
- Precondition for other PFM reforms such as:
  - Integrated Financial Information System
  - Medium Term Expenditure Framework
  - Performance  Budgeting

# Importance of Budget Classification 2

- **For control, definition of budget or sub-budget, linking receipts and payments (*fund*)**
- **Budget control by institution (*administrative*)**
- **Budget control by type of receipt or payment (*economic [revenue & expenditure])***
- **Budget control by policy objectives and results (*program*)**
- **Aggregate fiscal monitoring (*economic*)**
- **Historical and policy analysis (*above + functional, territorial, financing by sector)***

# Main Features of Sound Budget Classification 1

- Comprehensiveness – budget should cover all general government sector entities and present consolidated, complete view of them
- Unity – budget should include all receipts and payments of all general government entities
- Internal consistency – e.g. current should be consistent with capital expenditures
- Stability – classifications should not change often, as familiarity promotes understanding
- Minimum classifications – administrative, economic, functional

# Main Features of Sound Budget Classification 2

- **Distinction between administrative and economic classification - institutional responsibility vs. type of revenue/expenditure**
- **Independence between administrative and economic categories within classifications – to avoid confusing use of classifications**
- **Functional classification, independent of the administrative & economic classifications, should be used to analyze expenditure by broad purpose**
- **Mutual exclusivity – every line item should be independent of every other line item**

# Desirable Classification Structure 1

- *GFSM 2001* **is standard framework for improved or new budget classification but needs adapting:**
  - **For a budget defined on a cash basis: delete consumption of fixed capital**
  - **For a budget defined on a gross basis: separate sales and purchases of assets and liabilities**
  - **To add necessary sub-categories and transactions in assets and liabilities to economic classification**
  - **To add necessary classifications: administrative, fund, territorial and program**
  - **Possibility of adding program classification as expansion of functional classification (COFOG)**

# Desirable Classification Structure 2

- **Possible to use the fund classification for earmarked loans and grants – as sub-funds**
- **Possibility of classification of beneficiaries of transfers and subsidies**
- **Can add binary coding to functional or program coding to track poverty-reducing expenditure**
- **Codes should have clear descriptions, no overlap or gaps and permit required aggregation (hierarchy)**
- **Functional classification – independent data entry not always practical but bridge table from administrative classification undermines independence**

# Desirable Classification Structure 3

- **To be used properly, a program classification requires:**
  - **Clear institutional accountability for programs and activities: but it is difficult to align them with administrative structure especially if programs cross ministries**
  - **Clarity in definition of programs, activities, outcomes, inputs and outputs: more difficult in practice than in theory**
  - **Avoidance of bias in costing: difficult when allocating joint costs and when using cash basis for costing**
  - **Manageable data on outputs and outcomes: difficult when unbiased and meaningful performance indicators required**
  - **Hard budgetary control by programs and activities and relaxation of budgetary control by inputs: difficult to achieve in a weak control environment**

# Budget Classification and COA 1

- Lack of integration of budget and financial accounting causes reconciliation and data quality difficulties
- Integration has different meanings, for example:
  1. Central database systematically associates entries in the budgetary records with entries in the accounts
  2. Bridge table between budget classification and COA
  3. Separate part of accounts to record budgetary transactions
- Difficult to assess these options without detail
- Difficulty also created by different meanings of COA:

  (1) structure of double entry general ledger; or

  (2) coding structure for entire classification system including (1)
- IMF Technical Note *Transition to Accrual Accounting* implies: integration meaning 3 and COA meaning (1)

# Budget Classification and Chart of Accounts 2

- This approach to integration applies discipline of double entry accounting to budgetary accounting by economic classification
- If COA must enable generation of accrual information, the problem, under this integration approach, is to generate cash information itemized by economic classification when such itemization in the general ledger is normally at accrued expense stage
- Two options: (i) subsidiary ledger of the cash accounts; (ii) auxiliary accounts of "COA". Both reflect economic classification
- (i) achieves integration by control cash accounts in the general ledger, summarizing single entries in subsidiary ledger.
- (ii) requires duplication of accounting entries in auxiliary accounts, therefore strictly speaking are not part of general ledger or COA
- Both (i) and (ii) may have IT issues: (i) requires subsidiary ledger functionality and (ii) may require ledger software customization

# Preconditions for Successful Implementation

- **Political ownership**
  - **Commitment and leadership at highest level of government**
  - **Support of parliament for any necessary legislation and to accept new format in budget presentation and reporting**
- **Technical capacity**
  - **MOF must have sufficient skilled and trained staff**
  - **Strengthened capacity also required in Treasury, line ministries and external audit chamber**
  - **Outside consultants supplement but do not substitute**
- **IT systems**
  - **Can be implemented manually, but use of an IT system is preferable to strengthen accounting and enhance reporting**

# Critical Steps

- Can be lengthy process, especially if new classification integrated with chart of accounts
- New classification should be completed at least six months before implementation, and amended chart of accounts at least two months
- Transitional period must allow sufficient time for:
  - Parliament, external audit chamber and line ministries to review  new classification
  - Operational guidelines developed and training performed
  - Amendment of legal framework

# Thank you for your attention.