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## A Review of Capital Budgeting Practices

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**A Review of Capital Budgeting Practices**

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**Abstract**

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A key challenge in government budgeting is to define an appropriate balance between current and capital expenditures. Budgeting for government capital investment also remains not well-integrated into the formal budget preparation process in many countries. This paper aims to provide an overview of past and current budgeting practices for public investment. The study will also provide a comparison between the budget practices between low-income countries and developed countries and make a series of recommendations for how to ensure efficient integration of capital planning and budget management in low-income countries.

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## I. INTRODUCTION

In general, capital budgets<sup>2</sup> in governments have multiple roles: as instruments of fiscal policy and to improve the net worth of government, and—particularly in the area of economic infrastructure—as vehicles for economic development. This is usually achieved through greater reliance on debt than on such conventional sources of financing as taxation. Governments have introduced capital budgets to serve all these objectives, singly or collectively, depending on the context. In some cases, more attention has been paid to capital budgets as a way to reduce deficits caused by an excess of recurrent expenditures versus revenues.<sup>3</sup>

Notwithstanding the seeming virtues of capital budgets, opinions continue to be divided, as they have been during the past seven decades, about their utility in governments. In the present context, in which some more advanced countries have budgetary surpluses and use them to reduce levels of public debt, there is little incentive to revive the debate about the need for capital budgets. In the developing world, however, where many governments operate on the edge of financial instability, the debate about capital budgets and their equivalents continues.

A key challenge in government budgeting is to define an appropriate balance between current and capital expenditures. Budgeting for government investment also remains not well-integrated into the formal budget preparation process in many countries. Experience shows that in the absence of properly organized capital budgets, governments resort to borrowing without due consideration of the sustainability aspects, assets are inadequately maintained, and major projects suffer from overall poor management and performance.

It is arguable whether these poor results could have been prevented by the establishment of capital budgets. Moreover, for countries that continue to depend on debt finance as a major instrument of budgetary resources, the issue arises whether capital budgets promote an improved process of decision making and an overall management culture that permits continuing attention to the government's net worth. For both these reasons, it is important to revisit the debate about capital budgets. More specifically, it is important to consider whether capital budgets provide an improved framework for allocating, using, and accounting for resources.

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<sup>2</sup> *Capital budgets* in this context refers to budgets that are self-contained and separate from the budget for recurrent expenditures. The term *investment budget* is sometimes used as well to emphasize the importance of public investment (on e.g., economic growth). These two concepts are similar and distinct from the concept of a *development budget*, which includes expenditures that are not related to investment.

<sup>3</sup> See Webber, 2007, pp. 1–2.

This paper aims to provide an overview of the evolution of past and current budgeting practices for capital budgets. The paper will also provide a comparison between the budget practices between low-income countries (LICs) and more advanced countries, and make a series of recommendations to ensure more efficient integration of public investment planning and budget management in LICs.<sup>4</sup> However, the paper will not aim to address other important and related issues such as public-private partnerships and other mechanisms for outsourcing the costs and risks associated with capital investment projects; the earmarking arrangements and extrabudgetary funds, e.g., road funds; procurement and project management; and, efficient asset management strategies and their link with the budget.

## II. OVERVIEW OF CAPITAL BUDGETING PRACTICES

### A. Introduction

The United Nations' *System of National Accounts* (SNA) and the IMF's *Government Finance Statistics Manual 2001* (GFSM) prescribe how a government's consumption and investment activities should be separately recorded in the government budget and in accounting records and statistics.<sup>5</sup> Box 1 below provides an overview of the possible methods to define "capital."

#### Box 1. Defining Capital

Governments around the world may define "capital" in different ways. *Capital spending is generally about physical assets with a useful life of more than one year.* But it also includes capital improvements or the rehabilitation of physical assets that enhance or extend the useful life of the asset (as distinct from repair or maintenance, which assures that the asset is functional for its planned life).

Capital spending is sometimes equated with *investment* or *development spending*, where expenditures have benefits extending years into the future. Under this definition, governments may include physical assets for government use (for example, office buildings), physical assets of a public good nature that also enhance private sector development (for example, roads, water systems), and intangibles (for example, education, research). It can be quite difficult to distinguish between investment and noninvestment expenditures, and if investment spending receives favored treatment in the annual budgeting process, nearly all spending, whether recurrent or not, will end up being classified as investment.

Every government establishes some arbitrary cut-off point to distinguish capital from current expenditures. For budgeting purposes, the relevant distinction is between capital and current (or operating) expenditures. Current expenditures are purchases of assets to be consumed within one year, regardless of expenditure size. Small expenditures (for example, less than US\$25,000) are regarded as current, regardless of the fact that it could be consumed over a period longer than one year.

<sup>4</sup> See also Gupta, S. et. al., 2008, p. 25.

<sup>5</sup> Sarraf, 2005, p. 4 also discusses this aspect.

Source: World Bank, “Ukraine: Creating Fiscal Space for Growth: A Public Finance Review,” Report No. 36671-UA, 2006: p. 84.

But even given the different definitions of capital<sup>6</sup>, it does not necessarily call for a dual budgeting system. Separate data on government consumption and investment can be maintained within a unified government budget.

This paper is concerned mainly with public investment. However, some of the most common and serious problems with public sector capital budgeting can arise from its interface with current spending.

### **The distinction between capital and current expenditure**

Capital and current expenditures need, for some purposes, to be considered separately:

- capital spending within the budget needs to be clearly identified *separately*; and
- *capital-specific procedures* are needed for asset procurement and for project management, and for subsequent monitoring and management and disposal of capital assets.

For other purposes, capital and current expenditures need to be considered together:

- For planning and budgeting capital and current spending need to be considered *together*; and
- investment proposals need to be appraised in terms of *both* capital *and* operating costs.

The structure of a capital budget can be illustrated as set out in Table 1 below. Contrary to general belief, the funding of a capital budget can be more than borrowing—although depending on the situation, borrowing may be the most important source of funds. In principle, taxes levied on property, although paid from current income, are considered levies on capital and included in capital receipts. In some countries, income from natural resources (including oil) may be earmarked for capital projects and, therefore, included in receipts. In countries with development plans, surpluses from the current budget (relatively less during recent years owing to the significant growth in current outlays) are yet another source of receipts. Depreciation allowances represent, in accounting parlance, a *contra* or a balancing entry, in that allowances that are charged to the current account are treated as capital receipts.

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<sup>6</sup> Sometimes the commonly used term of “investment in human capital” could also be used, but this should be distinguished from investment in social infrastructure (schools, hospitals, etc.).

The receipts section includes capital transfers from external sources and proceeds from the sale of property and privatization.

It is normal in developed economies for the section in the ministry of finance, that is familiar with a spending unit's activities, to deal with both capital and current spending. For each spending program, the budgeting of capital and current expenditure is developed together.<sup>7</sup>

Table 1. An Illustrative Example of the Structure of a Capital Budget

<b>Receipts</b>	<b>Expenditures</b>
1. Estate and death duties <ul style="list-style-type: none"> <li>• Taxes and property</li> <li>• Earmarked revenues for capital projects</li> </ul>	1. Acquisition of existing assets <sup>8</sup> <ul style="list-style-type: none"> <li>• Plant, property, and equipment</li> <li>• Financial</li> </ul>
2. Surpluses from the current account	2. Acquisition of new assets <ul style="list-style-type: none"> <li>• Plant, property, and equipment</li> <li>• Financial (other than capital transfers)</li> </ul>
3. Proceeds of borrowing: <ul style="list-style-type: none"> <li>• Domestic</li> <li>• Trust and captive accounts maintained by government</li> <li>• External</li> </ul>	3. Capital transfers <ul style="list-style-type: none"> <li>• Transfers to other levels of government</li> <li>• Transfers to state-owned enterprises</li> </ul>
4. Depreciation allowances	4. Repayment of loans
5. Sales of property <ul style="list-style-type: none"> <li>• Regular</li> <li>• Privatization</li> </ul>	
6. Capital grants	
<b>TOTAL</b>	<b>TOTAL</b>

Source: Premchand in Shah, 2007: p. 94.

The annual government budget for all public spending in most developed countries is broken down into several hundred headings for approval by the parliament. Each heading is usually wholly capital spending or wholly current spending. Indeed parliaments often require capital

<sup>7</sup> See Spackman, 2002, p. 9.

<sup>8</sup> The acquisition of existing assets are not considered as "investments" in the System of National Accounts (SNA), because in the SNA an investment implies the creation of new assets.



expenditures to be specifically identified in the budget documentation. However, presentation and debate in the parliament and in public focuses on the expenditure programs as a whole.<sup>9</sup>

However, program budgets in these countries still have capital and current components, usually with only limited freedom (if any) to vire between them. Capital and current expenditure are also distinguished in the *accounts* of spending units and in *reporting* expenditure. Development of capital investment plans is usually seen as an issue for the internal management of line ministries or agencies.<sup>10</sup> Specific ministry of finance approval may be needed for some large capital projects.

### **Golden rules, balanced budgets and limits on borrowing**

Some countries have or are developing explicit links or rules between the level of net public investment and the level of public debt. This may include “the golden rule,” which specifies that increases in the stock of public debt should not exceed net public investment.

There has also been increasing interest in recent years in rules limiting the budget balance and the total level of public debt. These developments were reinforced in the European Union in the 1990s by the conditions for membership of the Monetary Union, which put limits on budget deficits and the total level of debt. These have been now succeeded by the Stability and Growth Pact, which limits the level of public sector deficit.

The golden rule and budget balance are specified in the German Constitution. However, a law was passed in 1967—at a time when public investment was still widely seen as an instrument for controlling unemployment—allowing exceptions for federal and state governments where more public investment is considered justified by macro-economic conditions. This exception has been applied many times. The Netherlands applied the golden rule between 1927 and 1958. In 1997, the U.K. government introduced a policy under which the budget is balanced over the economic cycle, with no exceptions, and a target is set for the level of government debt.<sup>11</sup>

Control of public debt is at least as important in low-income countries as in developed economies. However, the first priority is to develop reliable measures of public assets and,

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<sup>9</sup> For example, the Netherlands had separate capital and current budgets from 1927 to 1976; subsequently there has sometimes been pressure to return to this arrangement, from those who believe that this may lead to more public investment, but these arguments have been resisted (Spackman, 2002, p. 10).

<sup>10</sup> There may be a “public works agency” which manages a wide range of public service construction work, but the trend is toward delegating these functions, and the appraisal of the investment is anyway a task for the agency whose program it is supporting.

<sup>11</sup> See Spackman, 2002, p. 13.

especially, liabilities. Information on capital assets and liabilities should ideally be monitored, and some countries have found it helpful to establish some form of the golden rule.

### **B. The Evolution of Capital Budgeting Practices**

Budgeting for capital expenditure has evolved over the decades and its importance has increased (or decreased) over time. Overall, six discernible stages of changes in capital budgeting practices and systems can be identified.<sup>12</sup> The first stage is the Great Depression years during which efforts were mainly focused on designing ways to ensure economic recovery. At the time, public borrowing for financing capital outlays, except for emergencies, was not favored. In a cautious approach, Sweden introduced a capital budget that was to be funded by public borrowing and used to finance the creation of durable and self-financing assets that would contribute to an expansion of net worth equivalent to the amount of borrowing. This so-called investment budget found extended application in other Nordic countries in following years.

The second stage took place during the late 1930s when the colonial government in India introduced a capital budget to reduce the budget deficit by shifting some items of expenditures from the current budget. It was believed that the introduction of this dual-budget system would provide a convenient way to reduce deficits while justifying a rationale for borrowing.

The third stage refers to the growing importance attached to capital budgets as a “vehicle” for development plans. Partly influenced by the Soviet-style planning, many low-income countries formulated comprehensive five-year plans and considered capital budgets the main impetus for economic development.<sup>13</sup> Where capital budgets did not exist, a variant known as the *development budget* was introduced.<sup>14</sup>

### **C. Capital Budgeting in the 1960s to 1990s**

The fourth stage reflects the importance of economic policy choices on the allocation of resources in government. Quantitative appraisal techniques were applied on a wider scale during the 1960s leading to more rigorous application of investment appraisal and financial planning.<sup>15</sup>

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<sup>12</sup> See Premchand in Shah, 2007, p. 91.

<sup>13</sup> See Tarschys, 2002, p. 85.

<sup>14</sup> See footnote 2.

<sup>15</sup> See Premchand in Shah, 2007, p. 91.

In the 1960s and 1970s, it was widely believed that government budget allocation, including investment expenditures, could be largely reduced to a “scientific” process by systems such as PPBS (planning, programming and budgeting system) or even ZBB (zero-based budgeting).<sup>16</sup> Spackman believed that this turned out not to be true, for three main reasons. One reason was that, for most public policies, finding the best way forward depends not only on analysis but very largely on pragmatism, political intuition and windows of political opportunity. Second, the information demands were equivalent to those required to run a centrally controlled economy. Third, the implied power structure within government was that of control in detail from the center, as opposed to delegated authority, incentive structures and local initiative.

A fifth stage<sup>17</sup> saw a revival of the debate about the need for a capital budget in government, particularly in the United States. Along with the growing application of quantitative techniques during the 1960s came the view that the introduction of a capital budget could be advantageous. But this view did not gain much support. A president’s commission in 1999 investigating budget concepts in the United States concluded that a capital budget could lead to greater outlays on bricks and mortar, and as a result, current outlays could suffer. Having rejected the use of separate capital budgets, the commission advocated the introduction of accrual accounting in government accounts. The introduction of accrual accounting,<sup>18</sup> which did not make any progress in the United States until the early 1990s, would have meant the division of expenditures into current and investment outlays.

Meanwhile, however, a development cast more serious doubts on the need for capital budgets. Sweden (and other Nordic countries), which had made pioneering efforts in the 1930s, undertook a review of its budget system in the early 1970s. They found that excessive focus on capital budgets would need to be tempered by a recognition that the overall credibility and creditworthiness of a government depend more on its macroeconomic policy stance and less on a government’s net worth. This shift in emphasis contributed to a decline in the popularity of the use of the capital budget until the late 1980s, when it came to be revived in a different form. By then, government officials recognized that the management of

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<sup>16</sup> The term PPBS is still sometimes used to describe any well balanced, analytically based approach to planning expenditure programs. However, it was originally presented as a way of deriving by rigorous analysis the “optimal” allocation of expenditure. At the “planning” stage, systems analysis identified objectives and potential solutions. “Programming” applied economic techniques such as cost-benefit analysis to existing and potential new policies. “Budgeting” applied the results of this analysis to derive annual budgets. ZBB was a later experiment, which applied a rather similar, comprehensive logic to individual programs.

<sup>17</sup> See also Premchand in Shah, 2007, p. 91.

<sup>18</sup> Accrual accounting is an accounting methodology under which transactions are recognized as the underlying economic events occur, regardless of the timing of the related cash receipts and payments.

government finances required a new approach, and this approach was the application of accrual accounting.

During this sixth stage, partly because of the experiences of Australia and New Zealand, there was a renewed push by the professional bodies and, from the late 1990s, the international financial institutions for the introduction of accrual budgeting and accounting. These ideas found a foothold in the United States, where advocates held the view that the absence of a distinction between investment outlays and ordinary or current outlays led to unintended neglect of infrastructure or accumulated assets. Ensuring proper asset maintenance (as important as asset creation) required a division of outlays into current and capital outlays, as a part of day-to-day budget management.

### **III. CURRENT CAPITAL BUDGETING PRACTICES**

#### **A. Capital Budgeting in Developed Countries**

Dual budgeting originated in European countries, but in those countries it lasted only for a short period. It was introduced in the late 1930s in order to help governments ensure that the resources they borrowed were used only for capital expenditures.<sup>19</sup> After the Second World War, as governments relaxed their use of borrowed funds, budgets were integrated. The change in approach reflected several factors: massive postwar reconstruction work and increased recurrent expenditures, along with the acceptance of the Keynesian model of linking government spending and the size of the budget deficit and borrowing requirements to both fiscal and monetary determinants and the business cycle. Moreover, it soon became clear that the need to reap a return—whether financial, social, or economic—applied to the entire spectrum of government spending.<sup>20</sup> Hence, it came to be accepted that regardless of their financing sources, government’s recurrent spending and capital investment are complements in any logical combination that may be required, and that the two types of expenditures together produce results, provided the context is one of overall macro-fiscal balance.<sup>21</sup>

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<sup>19</sup> Detailed information on the creation of dual budgeting in the U.K. and Sweden in the 1930s and 1940s can be found in A. Premchand, “*Government Budgeting and Expenditure Controls—Theory and Practice*,” International Monetary Fund, 1983, pp. 292–302.

<sup>20</sup> The U.K. government, in an effort to keep its budget deficit in a fiscally sound range, has in recent years reintroduced the golden rule of limiting capital expenditures to the size of borrowing, but this should be regarded as a self-imposed fiscal discipline measure only, and has not created any type of dual budgeting.

<sup>21</sup> In the United States, periodic recommendations were made for the introduction of a separate capital budget. But this never materialized, primarily because it might tilt the resource allocation in favor of “bricks and mortar.” However, the budget documents presented a special analysis of investment expenditures, which was for information only and had no accounting or other implementation impact for the budget structure.” For further details see A. Premchand, *op. cit.*, p. 302.

Most OECD countries have also achieved a high degree of integration of their current and capital budgets. This has usually occurred through a process of development in their public administration and budgetary systems that has taken place over many decades. It is the result of a growing realization by these governments that: (i) the distinction between recurrent and capital spending is often quite arbitrary or uncertain; and (ii) better resource allocation and management decisions can often be made within a single, unified (and medium term) framework for revenues and expenditures.<sup>22</sup>

While there are now few developed countries which maintain totally separate budgets, the extent and form of budgetary integration—particularly the management of capital spending—still differs significantly in some instances. For this reason, effective integration of current and capital budgets is perhaps best measured qualitatively by the extent to which the current and investment spending decisions of the government are “well-balanced,” in the sense of being logically consistent with, and mutually supportive of, a given policy framework or set of policy objectives. In practice, this means that the services for which government departments and spending agencies are responsible are delivered as effectively and efficiently as possible, given the budget resources available.

A few examples of these unsatisfactory balances between current and capital spending can be highlighted, which can often be found in the education sector—e.g., many teachers but too few or poor quality classrooms and teaching facilities. Similarly, in the health sector there may be large new hospitals, but insufficient trained staff or inadequate maintenance and funding for utilities. More general imbalances may also develop between expenditures on administrative services of government (especially salaries and allowances) and broader infrastructural development needs.

Although many developed administrations may not consciously seek to optimize this current/capital spending balance, they nonetheless aspire to achieve consistency and efficiency within the context of their on-going resource allocation and budget management decisions. In fact, getting the right balance between current and capital spending across the whole range of budget interventions and activities will depend substantially on the quality of budget planning systems and capabilities. While these issues may involve a much wider range of factors than simply the extent of budgetary integration *per se*, there is no doubt that a unified budget generally makes it easier to develop better systems, policies and capabilities in these areas.

The budget systems of countries with a high degree of integration between current and capital expenditures exhibit several key features:

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<sup>22</sup> See Webber, 2007, p. 2.

- a single (combined) annual budget law and appropriation process;
- clear, and unified, responsibilities for budgetary preparation and implementation within the relevant public sector institutions;
- the existence of effective and widely employed investment appraisal techniques;
- a unified budget presentation, with supporting classification and accounting systems; and
- budget planning and management techniques within individual spending agencies that encourage and enable good use of financial resources.

Most developed countries' budgetary systems incorporate some of these features. However, the full benefits of a unified budget can only be achieved where each of these conditions is present. And although each of these features is important, it is often in the last area—the budget planning and management within spending agencies—where the most challenging reform measures, and greatest gains, are to be found.

### **A medium-term approach to public investment**

Above-mentioned characteristics of a sound budgetary system are often strengthened by the use of a medium-term approach to public investment. Public investments are primarily meaningful in a medium- to long-term perspective. If the sole focus is only on preparing and executing the annual budget, the main reasons for pursuing investment projects will be related to short-term macro-economic effects, for instance on employment, and short-term political considerations. In such a setting, the potential long-term effects of the investments may be accorded little importance. As a result, the capital budget will tend to be underfunded. In addition, project selection will tend to prioritize high-visibility, fast-track projects, not the projects that give the highest net benefits.

Allocation of resources to different sectors and investment projects should ideally be based on efficiency. What are the benefits compared to the costs of the projects? In the short term, the main focus will tend to be on static efficiency: what are the expected results of allocating resources to certain sectors based on their current capacity to deliver specific public goods and services? In a longer-term perspective, dynamic efficiency becomes more important: resource allocation should also be governed by the possibilities for improving the capacity of the sectors over time, and investment projects will play a critical role in this regard.

It is also important to pursue cost-effective delivery of individual public goods and services. In the short term, efforts to improve cost-effectiveness will tend to focus on cost minimization, without any fundamental changes in production processes and methods. In a longer-term perspective, it will be possible to pursue more ambitious modernization and re-

engineering of the way in which government agencies operate, while still producing the same type of public service. Such restructuring will often require investments.

Many of the efforts to extend the time horizon for investment planning also include the introduction of medium-term budget frameworks (MTBFs). There are many differences between countries in the exact nature of these MTBFs, and in their focus and level of detail. However, in general, effective MTBFs tend to share certain characteristics:<sup>23</sup>

- The ministry of finance develops a medium-term macroeconomic forecast, which forms the basis for multi-year spending ceilings by organizations or programs.
- The line ministries develop policy-based, three-year budget estimates for their activities. These estimates should reflect ministries' strategies and policies.
- The ministries' budget estimates distinguish clearly between the costs of existing policies and programs, and the costs of new proposals, including investments.
- The budget preparation process gives a formal status to the out-year estimates. On a rolling basis, the first out-year estimates of expenditures should become the basis of preparation of the following year's budget.

Currently, the majority of OECD countries prepare comprehensive MTBFs. Few low-income countries have been able to introduce full-fledged MTBFs so far. Experience shows that this type of reform is conceptually and practically very demanding. In particular, it has turned out to be difficult for line ministries to develop credible, multi-year budget estimates.

Several important stages of the budgetary management of public investment can be distinguished<sup>24</sup> (see Table 2 below). Some activities highlighted in Table 2 are planning; some are control; some (such as procurement) entail planning, control and operational management. The degree of overall success in conducting these stages of budget management of public investment would depend on the maturity of the public financial management system in the country. In the more developed countries, most of these activities are well integrated into their budgetary processes.

A viable alternative is to begin by preparing multi-year budget estimates only for public investments and for major expenditures driven by demographics and entitlements. These estimates should be based on common methodologies, and the estimates should be agreed upon by the line ministries and the ministry of finance. While this approach does not provide

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<sup>23</sup> See Tandberg, 2007, p. 11.

<sup>24</sup> See Spackman, 2001.

the stringency of a full MTBF, it does give a much better basis for effective budget deliberations than the traditional, annual approach. Another factor that has been mostly successful only in developed countries is the development of a well-designed process whereby to appraise capital projects.

Table 2. Stages of Budgetary Management of Public Investment

Timing	Activity
Pre-commitment	<ul style="list-style-type: none"> <li>• Strategic objectives/strategies planning/detailed objectives</li> <li>• Option appraisal</li> <li>• Financing</li> <li>• Budgetary allocation</li> </ul>
Post-commitment	<ul style="list-style-type: none"> <li>• Procurement</li> <li>• Project management</li> <li>• Budget monitoring and control</li> </ul>
Post-completion	<ul style="list-style-type: none"> <li>• Asset management</li> <li>• Performance measurement</li> </ul>
After any stage	<ul style="list-style-type: none"> <li>• Ex post evaluation</li> </ul>

Source: Spackman, 2001: p. 215.

### The appraisal of capital projects

Most developed countries (and several developing countries) have had capital project appraisal processes for decades. However, there are differences of view between developed countries about some technical aspects of appraisal methodology.<sup>25</sup> However, investment appraisal in government is overall considered as a mainly economic analysis of the national costs and benefits which might be generated by the proposed investment, or by alternative options. Alternative options may include alternative locations, size, design, or timing of a new or renovated prison or hospital or defense establishment, and—especially—the alternative of not undertaking the investment. The appraisal in principle includes all costs, certainly including the costs of using the asset throughout its lifetime. It preferably should include a sensitivity analysis where costs or benefits are uncertain. It also considers items such as legislative impact or environmental impact, and any impacts on other sectors.

<sup>25</sup> Spackman, 2002, p. 12.



According to Spackman, the following requirements are crucial:

- well-informed and open-minded consideration of alternative options, against well-defined policy objectives;
- taking proper account of opportunity costs (so that the use of labor, for example, is normally recognized as a cost, and not seen instead as a benefit);
- consideration of factors which cannot be explicitly valued in money terms as well as those which can.

This contrasts with what is often understood by project appraisal in low-income countries, which is a *cost* analysis of an already well defined proposal. The capacity of some low-income countries to undertake such an analysis is often strong, whereas the capacity for *economic* analysis, to question initial proposals, is usually weak.

### **B. Capital Budgeting in Low-income Countries (LICs)**

For many countries, separate current and capital budgets—i.e., a “dual budget” process—have their origins in the public finance management policies and structures established by colonial administrations.<sup>26</sup> These administrations distinguished clearly between the recurring operational costs involved in maintaining a narrow range of government services and the “developmental” expenditures needed from time to time to establish new facilities or new administrative functions. Limitations on local revenue-raising capacities meant that approval for major capital expenditures often required special budgetary provisions including referral to the home treasury or supervising colonial authority.

Dual budgeting did not disappear, however, with the departing colonial administrations. The continued separation of current and development budgets also appealed to the new administrations in that it enabled them to separate the ongoing costs of government—and the associated raising of current revenues—with ambitious new development plans and their associated financing needs. Development assistance donors have reinforced this separation over the years through their traditional preference for funding of “development” activities, while at the same time shying away from the “consumption spending” associated with current expenditures. This traditional view of current expenditures as being of lesser economic importance, or merit, has diminished in recent years, especially within the multilateral institutions, though it is still evident in the chronic underfunding of some government services.

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<sup>26</sup> See Webber, 2007, pp. 1–2.

During the 1960s, low-income countries' nascent institutions of political and economic management tended to adopt the technical practices of the western democracies. For example, most Anglophone African countries used dual budgets, with an "above-the-line account" showing revenues and mainly "recurrent" expenditures, and a "below-the-line account" showing "extrabudgetary," interest and lending to nationalized industries and a very few local governments, where the latter implemented a central government's investment plans.<sup>27</sup> Many countries in Africa, Latin America, and the Middle East adopted national development planning, which had European roots and was still being practiced in Belgium, France, and Spain. Inexperienced finance ministries could not carry out the new tasks of medium-term development planning and capital project appraisal, so planning or development or economic affairs ministries were set up for the purpose.<sup>28</sup> In practice, the new ministries soon became responsible for the identification, appraisal, budgeting, and even accounting and reporting of investment budgets in an initial but major and lasting step toward dual budgeting.

Frequently, finance and development ministries issued their own separate budget circulars, and the dual approach to budgeting also took root in the line ministries. Politically visible gaps in physical infrastructure, and then capital project supremacy in government budgeting, helped to create new financial power bases, leaving the finance ministries responsible for budgeting civil service salaries and the needs of some small government ministries with minimal operational expenditures. Lack of coordination between the finance and planning or development ministries may also have reflected differences between their ministers and/or heads of state who, in some cases, exercised *de facto* control of investment decisions and their funding. Such settings made it difficult to introduce consolidated budget presentation and classification systems. Moreover, some substantial but unforeseen recurrent costs evolved from the expansion of investment projects.<sup>29</sup>

International lending institutions and the donor community at large found the new ministries more capable than weak finance ministries of conducting business in the area of capital

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<sup>27</sup> The "below-the-line account" used by the U.K. before the 1960s differs from the "below-the-line" concept used today in some fiscal terminologies (mainly verbal rather than written) for defining the balance of government operations and how its deficits are financed. Additionally, the term "below-the-line accounts or funds" is also used in some Anglophone African countries for another meaning, i.e., transferring some amounts from a ministry's budget to a special fund, at times supplemented by earmarked revenues and spending them outside government mainstream accounting and reporting procedures, including different classifications, carryover of funds from one year to another, minimum or no reporting, etc.

<sup>28</sup> However, it should be noted that some Latin American countries have weak Planning Ministries and strong Ministries of Finance (e.g., Uruguay, Guatemala).

<sup>29</sup> In some countries, although the minister of finance may have presided over the planning commissions or planning ministries, the latter were directed from the presidency. For details, see I. Lienert and F. Sarraf, "*Systemic Weaknesses of Budget Management in Anglophone Africa*," IMF Working Paper, WP/01/211.

spending, as well as so-called developmental recurrent spending. The donors' responses further institutionalized the practice of separate organizations preparing separate budgets. Though the use of public investment programs (PIP) in the 1980s, as promoted by the World Bank and other donor agencies, saw the introduction of more coordinated project selection and appraisal processes, replacing individual project appraisal, it intensified the dynamics of dual budgeting. Moreover, additional donor support to recurrent developmental and humanitarian expenditures created further coordination problems with governments' traditional recurrent budgets.

Both before and during the PIP era, emphasis was placed on calculating the recurrent spending that capital projects would need after their completion, but in practice finance ministers were uninformed and reluctant or financially unable to provide the necessary funds. The lack of provision for recurrent funds added to the concerns that had already been created by the organizational separation of the two budgets. It might be argued that the main reason for under-budgeting of recurrent expenditures for completed capital projects was, and still is, general fiscal stress in low-income countries. But a counterargument is that the fiscal stress could have been projected before the projects were initiated. Alternatively, it might be said that other spending priorities always crowded out the claims of these projects on recurrent budgets. Both arguments point to the lack of coordination between recurrent and development budgets.

A less often mentioned problem in these circumstances was double or overlapping budgeting for the same or similar recurrent activities of government. Frequently, line ministries managed to receive funds from two sources for the same cause by negotiating separately with the finance and planning ministries. They succeeded in this not only because development budgets contained substantial noninvestment and nonproject related recurrent spending, in addition to capital spending, but also because the finance ministries had no proper information, either on the recurrent cost implications of the investment projects or on the independent recurrent expenditures being financed by donors—a problem that continues to date in most low-income countries.

In several countries, dual budget preparation in terms of contents, classification, and even calendars, resulted in two different budgets being presented to parliament. Even in some countries where the timing of budget presentation has been unified, the documentation, classification, and presentation format of the two budgets has remained separate. Typically, recurrent budgets were classified on the basis of line ministries and/or those ministries' programs and expenditure items, while budgets for capital projects and developmental recurrent spending were presented as a list of projects, mostly with identification of their funding sources, but with little or no expenditure itemization.

The main impact of a dual budgeting system on budget execution and reporting occurred through capital or recurrent projects financed by donors, which usually required governments

to keep separate accounts for domestic counterpart funds and to deposit such funds along with donor funds in special bank accounts, outside the purview of central treasuries or accountants-general. These special accounts, mainly in commercial banks, were governed by flexible spending rules and often bypassed the national budget systems, undermining the objective of comprehensive government accounting, banking, and cash management coverage. Moreover, to ensure the availability of funds for recurrent expenditures of selected capital projects, government authorities created expedients such as extrabudgetary funds and trust accounts, whose transactions were subject to separate accounting and banking rules. This contributed to weaker reporting and delays in closing government accounts, due to the difficulty of reconciling government accounting records with government banking transactions. Although in most countries central treasury offices and accountants-general issued circulars requiring line ministries to report their transactions, in practice these reports were not complete or timely.

Special project management units were created in line ministries, dealing with the accounting and banking of the cash components of external loans and grants, as well as with government counterpart funds. Since these recurrent and capital transactions were not classified in terms of the object of expenditures, in practice the decision to itemize expenditures was entrusted to line ministries in the course of budget execution. Several line ministries did not use the government standard object classification that was used for traditional recurrent expenditures, thereby multiplying the accounting and reporting problems.

Since the late 1990s, new financial assistance policies and instruments such as poverty-reduction strategy papers (PRSPs), monitoring of poverty-reducing expenditures, sector-wide and budget support approaches have been changing the dynamics of donor/client relationships. Moreover, responding to urgent needs in health, education, and other sectors in poor countries, several donors have substantially increased their financing of recurrent expenditures. The new approaches have implications for consultations, conditionality, and data requirements, and for technical assistance to support an integrated approach to recurrent and development outlays. Public expenditure reviews (PERs),<sup>30</sup> as done by the World Bank, clearly have moved toward more intra-and inter-sectoral analyses, combining both recurrent and development expenditures, and where data are available, reviewing the joint impact of both types of spending on budgetary outcomes including economic growth, poverty reduction, and asset maintenance. But while most low-income countries have at least begun using medium-term expenditure frameworks (MTEFs) to replace five-year national plans and public investment programs, their annual programming and budgeting of recurrent and development operations still tend to be carried out by separate organizations.

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<sup>30</sup> PERs were originally *public investment reviews*, and reflected the World Bank's theory that capital investment would drive growth in developing countries. There was also a symbiotic relationship between the PIR and the PIP.

Some low-income countries have merged their finance ministries with their planning or development ministries, though others are slow in doing so. In many developing and transition countries, finance ministries have traditionally been much weaker than planning ministries which have benefited from close relations with the World Bank and other aid providers. The organizational separation of planning and finance ministries has become institutionalized in culture and politics in several countries. Political concerns about eliminating a ministerial portfolio, combined with institutional revivalism between the two ministries at the institutional level, persist in many low-income countries. On the other hand, in considering eliminating a ministerial portfolio, it should be kept in mind that governments can use their authority to create as many cabinet posts as they wish—say, for example, creating a ministerial post for environment or splitting the ministry of trade and industry into two.

Over the years, staff of planning or development ministries have tended to be better paid, and to benefit from various allowances and better professional treatment, than staff of finance ministries. Their favored position in part reflects the additional financing possibilities associated with externally financed projects. This feature might be a cause of difficulty in the integration of the two institutions.

Line ministries have a strong incentive to prepare and defend separate budgets because they can use the opportunity of donor-negotiated projects to demand further complementary financing and to expand their operations without attention to the future cost implications. These projects may include either capital projects or specific and independent recurrent activities. For line ministries, dealing with two separate central ministries for defending their budgets is more advantageous than dealing with one unified central budget authority, because they can take advantage of the two central ministries' lack of detailed information.

Today more than ever, the integration of recurrent and development budgets in low-income countries has become a necessity:

- government borrowing is no longer limited to capital expenditures;
- only an integrated analysis of recurrent and development expenditures can identify those poverty-reducing expenditures that have immediate impact (e.g., social transfers and targeted subsidies, and some other social expenditures) or an indirect impact through accelerating economic growth;
- part of external concessional credits, and the bulk of donor grants, are used for recurrent expenditures, supplementing the government recurrent budget; and
- even after several decades of experience, the recurrent costs of capital projects continue to be ignored, in part for lack of coordination between two separate budgets.

## **IV. DEVELOPMENT OF A REFORM STRATEGY FOR THE INTEGRATION OF INVESTMENT PLANNING AND BUDGET MANAGEMENT IN LICs**

### **A. Introduction**

Low-income countries' progress in integrating their recurrent and development budgets has been very limited. One factor that helps maintain the status quo is antiquated economic development theory, emphasizing capital spending for faster economic growth.

Another is institutional incentives. Donor practices have also tended to reinforce dual budgeting practices. Donors have traditionally focused on capital investments, and a desire to attract donor funding gives a country a strong incentive to maintain a separate development budget process, even though donors' use of budget support over project aid and multi-donor involvement in financing recurrent expenditures may increasingly change that incentive. The failure to ensure resources for ongoing maintenance of capital investments gives some agencies an incentive to seek earmarked or extrabudgetary revenues (e.g., road funds). On the other hand, some ministries pursue activities through the development budget that would otherwise be treated as recurrent spending, due to the budgetary incentives that are at work. Finally, the simple dynamics of separate ministries for finance and for development or planning, with their own domestic constituencies, and governments' general reluctance to reduce the number of ministerial portfolios, also work against the integration of recurrent and development budgets.<sup>31</sup>

It seems that some practical recommendations for achieving budget integration in low-income countries would be useful. In summary, the following benchmarks for budgeting for public investment can be suggested, however it should be noted that these recommendations represent what LICs might be able to attain over a period of years—in most cases LICs would only be able to focus their reforms on a few key areas.

### **B. Key Benchmarks for Capital Budget Planning, Prioritization and Implementation**

#### **Determining the resource envelope**

- Capital expenditure decisions should be based on a consolidated budget approach, incorporating all revenues and expenditures, in particular foreign-financed projects and extrabudgetary funds with investment activities.
- Capital expenditure decisions should be based on a medium-term budget perspective.

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<sup>31</sup> See Sarraf (2005) and Webber (2007) for a fuller description of these issues.

- Decisions regarding capital expenditures should be taken in the context of a hard budget constraint. There should be explicit ceilings for guarantees and commitments beyond the budget year.
- Governments should have clear policies regarding which capital expenditures should be financed by the budget, which may be realized through public-private partnerships and which should be handled by public or private enterprises. These policies should reflect the cost structure of the activities and the possibilities for user-financing, as well as political priorities.

### **Efficient prioritization and selection**

- The budget calendar and the procedures for integration of capital expenditures in the budget must be clear, transparent and stable. Development and analysis of capital investment proposals should largely be completed before the budget preparation process starts.
- All projects should be subject to cost-benefit analysis. If the subjection of all projects to cost-benefit analysis is too costly, the focus could firstly be on the larger projects, with using a simplified methodology for smaller projects.
- A public investment agency, with strong links to the Ministry of Finance, should prepare guidelines for project development and analysis. This agency should review project proposals to ensure that they are adequately prepared and analyzed, and have the authority to reject projects that do not meet the established technical standards.<sup>32</sup>
- The Ministry of Finance should give the cabinet recommendations for which investment projects should be realized within the available resource envelope. Ministries should compete for investment funds based on the net social value and political priority of their investment proposals.
- The decision to implement an investment project should be independent of the financing and procurement modalities for the project. PPPs can improve risk allocation, but the benefits must be substantial to compensate for increased financing and transaction costs. Decisions regarding PPPs should be an integral part of the budget process, and PPP arrangements should be fully disclosed in budget documents.

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<sup>32</sup> Most Latin-American countries have a “National System for Public Investment (SNIP)” whose key feature is an “investment project bank or database,” where the information on investment projects that were evaluated and considered economically viable is recorded.

### **Efficient implementation**

- Rules for budget adjustments should give incentives for realistic initial capital cost estimates. Cost overruns during project implementation should be partly covered by reallocation within ministry's existing budgets. In the case of real cost reductions, ministries should be allowed to retain part of these.
- Capital investment project proposals should only be considered when they include a detailed disclosure of the expected operating costs, indicating how these will be accommodated within existing resource envelopes or making an explicit proposal for additional financing of the operating costs.
- Capital investment project proposals should only be considered after the ministry has explained how it will fully cover the maintenance of its existing capital stock.
- Governments should avoid excessive targeting of capital expenditures for budget cuts. Decisions on budget cuts should be based on the medium-term budget and take full account of future expenditure pressures as a result of under-funding.
- There should be project completion reports for all capital expenditure projects. These should form the basis for cross-sectoral analysis and methodology development, and for continuous improvements in the investment process.

## **V. CONCLUSION**

The earlier recommendations for achieving budget integration in low-income countries could be critical for success. However, obtaining the necessary results could take the LICs several years. In summary, an effective capital budgeting process should form an integral component of a sound over-all budgeting system. A well-designed public financial management system supports each aspect of the system, including capital spending. Good multi-year planning furthermore supports overall fiscal balance, with more stable spending patterns for ministries and programs, and for their capital planning and execution. Good budget execution and procurement will enable timely, within-budget completion of projects (assuming good program and project management). Financial management information systems will support the financial and program management needs of the executive, ministries of finance and economy, spending ministries and program managers.<sup>33</sup> In addressing these aspects, LICs should continuously aim to improve not only their capital budgeting processes, but also their public financial management systems overall.

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<sup>33</sup> See Dorotinsky, W., 2008, IMF's PFM Blog at <http://blog-pfm.imf.org>.



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