

INTERNATIONAL MONETARY FUND AND  
INTERNATIONAL DEVELOPMENT ASSOCIATION

**Tracking of Poverty-Reducing Public Spending in  
Heavily Indebted Poor Countries (HIPCs)**

Prepared by the IMF's Fiscal Affairs Department and the World Bank's  
Poverty Reduction and Economic Management Network

In collaboration with other departments of the IMF and World Bank

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	Contents	Page
Summary .....		3
I. Introduction.....		5
II. Principles of Expenditure Tracking .....		6
III. Recommended Approach.....		10
A. Measuring HIPC Assistance .....		10
B. Medium-Term Goal: A Comprehensive Approach to Expenditure Tracking .....		11
C. Short-Term Approach .....		13
IV. Public Expenditure Management Systems in 25 HIPCs.....		14
V. Strengthening the Capacity to Track Poverty-Reducing Spending .....		22
Table		
1. Description of Expenditure Tracking Issues and Benchmarks .....		16
Charts		
1. Relative Needs for Upgrading Budgetary Systems .....		17
2. Need to Upgrade Systems for Tracking Poverty-Reducing Spending.....		18

Boxes	
1.	Poverty-Reducing Spending in PRSPs and Interim PRSPs (I-PRSPs).....9
2.	Budget Formulation .....20
3.	Budget Execution and Reporting .....21
4.	World Bank/IMF Ongoing PEM Work .....24
References .....28	

## SUMMARY

This paper (i) proposes an approach to tracking poverty-reducing public spending under the Enhanced HIPC Initiative; (ii) provides a preliminary assessment of the capacity of budget institutions to track poverty-reducing spending in 25 HIPCs that have reached the decision point or are expected to do so in the coming months; and (iii) suggests a way forward to strengthen the expenditure management capacity of HIPCs in both the short and medium terms.

The paper argues that **attempting to track *only* HIPC assistance would provide a partial perspective**, could undermine ongoing efforts to develop effective government budget systems, and may not ensure that poverty reduction targets are met. The proposed approach, therefore, is to develop systems to track the composition of overall government spending on poverty-related programs.

The paper draws on **preliminary assessments of the performance of public expenditure management (PEM)** systems in 25 HIPCs to identify strengths and weaknesses of those systems. It does not rank countries or their practices against one another but assesses relative needs by establishing benchmarks. These benchmarks are considered important for PEM systems to be able to track poverty-reducing public spending.

The 25 HIPCs surveyed have achieved improvements in their PEM systems in recent years, particularly in the comprehensiveness and classification of expenditures in budget formulation. In spite of the strides made, there is a clear need for further improvement if PEM systems are to facilitate tracking. The preliminary assessment finds that two of the 25 HIPCs should be able to carry out satisfactory tracking and reporting within one year, with a small amount of upgrading of their present systems. A further seven will require some upgrading to achieve the same objective over 1–2 years; and the remaining 16 HIPCs have PEM systems where substantial upgrading is required.

These findings suggest that “bridging” mechanisms are needed to track with existing data while continuing to strengthen PEM capacity. One approach being used in some HIPCs is a “virtual” poverty fund through which selected items in the budget identified as poverty-reducing are tagged and monitored as part of overall budget implementation. Used in conjunction with the monitoring of broad changes in the composition of public spending, virtual poverty funds can help track poverty-related spending identified in PRSPs. While this approach offers a good intermediate or bridging mechanism, HIPCs should also work simultaneously to develop more detailed classifications of poverty-reducing spending by program and to build well-functioning PEM systems for the medium-term.

**In most HIPCs, it is likely that countries’ own efforts will need to be supplemented with external assistance to meet the challenge of capacity building.** These efforts should build on the significant assistance that the World Bank and the IMF have provided to HIPCs in improving PEM systems, particularly in the last 3–5 years. Bank and Fund staff will follow up the desk assessments with more in-depth discussions with the HIPC

governments, both to finalize the assessments and to define poverty-owned programs of assistance. The extent of needs indicated by the preliminary findings suggests that **a significant scaling up of the assistance program is likely to be required.** Generating additional support, including from other multilateral organizations and the donor community, will be critical to ensure timely and reliable tracking of poverty-reducing public expenditure in HIPC.

## I. INTRODUCTION

1. **Public spending is a critical instrument for poverty reduction in developing countries. To have a significant impact on poverty, however, it must be budgeted and disbursed for activities that help the poor expand their access to resources and their income-earning potential:**

- From a development perspective, countries need to focus on the allocation and implementation of public expenditures as they formulate Poverty Reduction Strategies;
- From a fiduciary perspective, citizens and governments in donor countries need assurance that resources they provide under the Enhanced Heavily-Indebted Poor Country (HIPC) Initiative—henceforth HIPC assistance—are devoted to poverty reduction. When their assistance is provided through projects, donors often rely on donor-specified procurement and financial management regimes to provide such assurance. However, when assistance is provided in the form of general budget support, they must rely on public expenditure management (PEM) systems in the recipient countries. Such tracking should also provide a basis for donors to streamline their own conditionalities and their reporting and other procedural requirements, thus relieving the burden on the authorities;
- From a governance perspective, citizens and parliaments in recipient countries need reassurance that debt reduction resources are being used for the purpose intended;
- From a broader perspective, the capacity to track public spending also supports the ultimate aim of the HIPC Initiative of tilting the composition of overall public spending toward poverty-reducing programs;

2. **To review the capacity of HIPCs to track HIPC assistance, a joint World Bank-IMF Public Expenditure Working Group was established in June 2000 under the auspices of the Bank-Fund Joint Implementation Committee (JIC).** This paper summarizes the preliminary findings to date of the Working Group.

3. **The task of tracking government spending on poverty, in both the short and medium terms, is the country's responsibility.** Each HIPC is expected to design, execute, and monitor its poverty-reduction strategy and related public expenditure program, with the support of the World Bank, IMF, and other creditors and donors. Such country ownership, critical for implementation of good policies and for promoting accountability and good governance, is built into the process of drafting Poverty Reduction Strategy Papers (PRSPs).<sup>1</sup>

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<sup>1</sup> The World Bank's recently completed Strategy on Governance and Public Sector Reform stresses the critical importance of country ownership. See World Bank, 2000a.

4. **Tracking can also contribute to the objectives of other operations supported by the IMF and World Bank.** The support provided by the IMF through the PRGF and by the World Bank through PRSCs envisages a shift in public spending toward poverty-reducing programs. Improving the efficiency and effectiveness of existing public spending is thus a key objective of World Bank- and IMF-supported programs. Indeed, there is need to track poverty-reducing public spending in all low-income countries, including those that are not eligible for the Enhanced HIPC Initiative.

5. **The management and monitoring of public expenditures is not merely a technical challenge but also fundamentally a deeper governance challenge.** Public spending is a powerful tool of governments, and mechanisms are needed to ensure that decision makers make sound commitments and implement them, which requires appropriate incentives for accountability and transparency. Parliaments and civil society are expected to play an active role in this process.<sup>2</sup>

## II. PRINCIPLES OF EXPENDITURE TRACKING

6. **Perhaps the most fundamental principle of HIPC tracking is that it is neither feasible nor desirable to try to track *only* HIPC funding. Instead, *all* public spending on poverty reduction needs to be tracked, both to understand the impact of HIPC assistance and to encourage a shift toward more poverty-reducing public spending in the overall budget.** Countries with well-developed classifications can rely on existing systems to identify and track poverty-reducing expenditures. Where such systems are not yet comprehensive, setting up a “virtual” poverty fund offers a short-term approach. A virtual poverty fund is a limited classification designed to provide financial information specifically about poverty-reducing spending. Budget line items that are considered to contribute to poverty reduction are “tagged,” and these together constitute the virtual fund. All tagged items are monitored by the ministry of finance as part of overall budget execution. By using the existing budget processes, this approach avoids the pitfalls of a separate institutional mechanism (see below) while enabling tracking of all poverty-related programs.

7. **About two-thirds of the HIPCs have decided to use either pre-existing classification systems or a virtual fund to identify and track relevant poverty-reducing spending.** Virtual funds are taking several forms:

- Uganda, for instance, has established a Poverty Action Fund (PAF), which is really an accounting framework. PAF facilitates the identification of poverty-reducing programs at the level of budgetary line items. However, there is a need to identify these programs in the accounting coding structure to enable automatic tracking. It

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<sup>2</sup> See, for example, World Bank (2000a) and the following IMF Board papers: *Poverty-Reduction Strategy Papers—Operational Issues* (SM/99/290, 12/10/99); and *The Poverty Reduction and Growth Facility—Operational Issues* (SM/99/293, 12/13/99).

also acts as a vehicle for relating incremental resources provided by debt relief and donor support to expenditure increases for specific programs;

- Tanzania operated a Multilateral Debt Fund (MDF), established by the Nordic countries and the United Kingdom, which acted as a general government account in the Bank of Tanzania and was used for debt servicing to the multilaterals. The MDF is now being transformed into a Poverty Reduction Budget Support Fund, which will allocate HIPC assistance to programs in the central government budget identified in the PRSP;
- In Guyana, certain line items are tagged as poverty-reducing spending based on administrative, economic, and highly aggregated functional classifications.

8. **Due to concern that tracking of overall spending may be handicapped by weaknesses of PEM systems in HIPCs, the use of separate institutional poverty funds has sometimes been advocated as a means to channel and monitor the use of HIPC assistance.**<sup>3</sup> It has also been suggested that such arrangements might serve as a short-term bridge toward broader PEM improvements required to address the weakness of existing systems in HIPCs. However, the use of separate institutional poverty funds is inadvisable for several reasons:

- **First, institutional poverty funds do not necessarily capture additional spending on poverty-reducing programs.**<sup>4</sup> Resources are fungible, and a country can offset HIPC assistance earmarked for poverty-reducing programs by lowering its own spending in those areas.<sup>5</sup> This problem is compounded by the difficulty of determining a counterfactual, that is, what a government would have spent on poverty reduction without HIPC assistance.
- **Second, even in the absence of fungibility, a separate institutional fund would not provide assurance that sufficient resources were being committed to achieve**

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<sup>3</sup> Institutional poverty funds refer here to revenues set aside in a separate account, with expenditures occurring outside country's normal budget execution and reporting system, subject to different reporting and accountability standards, and frequently with dedicated local staff hired and paid outside normal civil service systems.

<sup>4</sup> In practice, the provision of HIPC assistance can be expected to lead to increases in social spending, given the low level of such spending in HIPCs: public spending on education and health averaged 3.3 and 1.6 percent of GDP, respectively, in a sample of HIPCs during 1998, compared to 4.6 and 2.5 percent of GDP in a sample of non-HIPC PRGF-eligible countries (see IMF, 2000, Box 4.3). However, in principle, it is also possible that HIPC assistance could be used to pay down domestic debt or lower tax rates, if these were viewed as more cost-effective ways of reducing poverty over time (e.g., through their impact on economic growth or inflation). See, for example, Ahmad and Stern (1987), who point to the potentially large benefits of reducing distortionary taxes in developing countries.

<sup>5</sup> Feyzioglu, Swaroop, and Zhu (1998) have shown that earmarked project aid to developing countries is largely fungible.

**targets for poverty reduction.** HIPC assistance channeled through such funds accounts for a small share of both public revenue and public spending.<sup>6</sup> Indeed, poverty-reducing spending would be expected to increase by more than HIPC assistance in most cases, given that the PRSP process raises the priority accorded to fighting poverty. The poverty-reduction targets set by many PRSPs envision the mobilization of additional domestic revenue and concessional foreign financing to complement HIPC assistance.

- **Third, creating separate institutional poverty funds would, in many cases, undermine the significant progress already achieved in most HIPCs in providing comprehensive budgets.** Diverting limited technical skills to create and manage these funds could aggravate problems of transparency, duplication, and governance in the budget as a whole. Such funds would make the budget less flexible without ensuring additional resources for reducing poverty.
9. Several additional issues arise in considering how to track poverty-reducing spending:
- **HIPCs are expected to define poverty-reducing spending in the context of the PRSP process.** This means that the definition of poverty-reducing spending will necessarily be country specific. It is important for countries to recognize that different types of public spending can contribute to poverty reduction, whether through their impact on the provision of direct services to the poor or through their impact on overall economic growth and security. Certain outlays (such as those for primary education and basic health care) tend to be counted as poverty reducing in all countries. However, others (e.g., for rural access roads and housing) may be specific to some countries (Box 1).
  - **Accurate identification requires an appropriate budget classification system.** A detailed budget classification by function, program, and economic object is needed to provide precise information on poverty-reducing spending, but such classification is often not available in HIPCs. Functional classifications are often not comprehensive and typically available only with a lag. For instance, out of the 25 HIPCs considered here, a functional classification of budget expenditures is available for only 9 HIPCs for 1999, and for 18 HIPCs for 1998.<sup>7</sup> Classification by program is rare.
  - **Even when poverty-reducing spending is identified, tracking requires effective government accounting and audit systems.** These systems have serious weaknesses and may not provide adequate oversight. Reports on public spending may not be timely or accurate or cover all relevant spending categories.

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<sup>6</sup> For the 22 HIPCs that had reached the decision point by end-2000, government revenue averaged around 22 percent of GDP and government spending around 26 percent in 1999, while projected annual HIPC assistance (on a cash basis) was around 2 percent of GDP over the period 2001–05.

<sup>7</sup> This is based on data supplied to IMF staff by country authorities.



**Box 1. Poverty-Reducing Spending in PRSPs and Interim PRSPs (I-PRSPs)**

**All PRSPs and I-PRSPs seek a shift in the composition of public spending towards poverty-reducing programs.** The degree of elaboration and specificity of policies and targets to achieve poverty-reduction goals varies across countries. To date, only four countries have prepared full-fledged PRSPs (Burkina Faso, Tanzania, Mauritania, and Uganda).

**The main features of country strategies are as follows:**

In general, most propose:

- enhancing access of the poor to **primary education**, with emphasis on reducing gender and regional disparities. The strategies also promote better quality and efficiency in the education sector;
- enhancing access to **primary and preventive health care** services; and
- Emphasizing **infrastructure programs** in the areas of water, roads, electricity and telecommunications;

Some also propose:

- Providing **housing** to the poor (e.g., Bolivia, Burkina Faso, Chad, Guyana, Honduras, Mali, Mozambique, and Uganda); and
- Strengthening **social safety nets** to include food subsidies or other food security programs (e.g., Burkina Faso, Cameroon, Mali, Mozambique, and Zambia), social assistance programs (e.g., Benin, Honduras, and Mozambique), labor intensive public works (e.g., Benin), and food for work programs (e.g., Tanzania).

**Targets vary in terms of the coverage of indicators, magnitude as well as the speed.** Some countries explicitly target yearly reductions in the incidence of poverty (e.g., Bolivia, Guyana, Honduras, and Mozambique). Intermediate targets often include goals for primary education (typically enrollment rates), basic health care (typically infant, child and maternal mortality rates), and the incidence of transmissible and endemic diseases, including HIV/AIDS), improvements in social infrastructure, and in some countries, reduction in regional and gender disparities.

- **Finally, devolution of poverty-reducing programs to local governments can make tracking more complex.** Fiscal data on subnational governments may be excluded from official reporting, may become available only with a long lag, or may be insufficiently detailed or accurate. Subnational governments currently account for more than 10 percent of poverty-reducing spending in only 6 of the 25 HIPCs surveyed, but this number is expected to grow given the trend toward greater decentralization. Thus, many HIPCs will need to focus over time, on strengthening PEM systems at the subnational as well as the national levels.

### III. RECOMMENDED APPROACH

10. **Tracking of poverty-reducing public spending under the HIPC Initiative should include a clear identification of the amount of resources released and an ability to assess the changes in the overall composition of spending.** If systems are not in place for a comprehensive and complete assessment, short-run approaches to tracking could be adopted, as discussed below.

#### A. Measuring HIPC Assistance

11. **A first step in tracking the impact of the Enhanced HIPC Initiative is to measure resources released by HIPC assistance.** HIPC assistance typically goes directly to the budget (the exceptions being assistance provided by the IMF and by other creditors on government-guaranteed debts of public enterprises). The various modalities adopted by creditors for delivering the assistance (grants, stock of debt reduction, or flow relief in the form of debt service rescheduling) and their impact on fiscal variables will need to be clearly shown in IMF and World Bank documents. Governments should also be encouraged to include data on HIPC assistance in their budget documents.

12. **HIPC assistance from the IMF may not immediately show up in the fiscal accounts.** IMF HIPC assistance reduces the burden of debt service paid by the central bank in most countries (the CFA franc zone countries being a notable exception). Countries may need to set up special accounts in the central bank to identify such HIPC assistance, and as the assistance is provided, transfers would be made to the budget as grants.<sup>8</sup> In the absence of such an arrangement, HIPC assistance would be reflected in profit transfers to the budget, but with a lag. This method may obscure the size of the transfer of HIPC assistance to the budget.

13. **Some HIPC assistance may accrue to public enterprises in the form of write-downs of public enterprise debt guaranteed by the government.** As with IMF assistance, such debt write-downs will not be included in the government budget unless arrangements are put in place to ensure that this assistance is passed on to the budget.

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<sup>8</sup> In several cases, central banks have already set up mechanisms to do so (e.g., Guyana, Honduras, Mauritania, Tanzania, and Uganda).

14. **Measuring resources released by HIPC assistance is complicated, because many countries may not have been meeting their full debt service obligations *before the Enhanced HIPC Initiative*.** When actual debt service paid was small or negligible due to accumulation of external arrears, HIPC assistance may be associated with increased debt service payments resulting from the regularization of relations with creditors. However, this regularization of relations could also trigger *additional* donor inflows.<sup>9</sup> A presentation of the *total* net external flows (external financing less scheduled debt service) to the budget before and after HIPC assistance would thus provide a more accurate picture of the country's external situation.

15. **Therefore, at least two presentations should be adopted to show the fiscal impact of HIPC assistance.** First, to measure the change in the country's external debt servicing commitments, scheduled debt service after HIPC assistance (after taking into account grants and rescheduling) should be compared with scheduled debt service before HIPC assistance (and after the hypothetical full use of traditional debt relief mechanisms). However, to show the cash impact on the budget, scheduled debt service after HIPC assistance needs to be compared with what was actually paid in previous years. Changes in donor flows should also be shown.

#### **B. Medium-Term Goal: A Comprehensive Approach to Expenditure Tracking**

16. **Once the overall size of HIPC assistance is identified, a PEM system should be able to determine how the total amount and the detailed allocation of overall poverty-reducing spending changes as a result.** This requires a baseline against which to assess changes in overall spending. Ideally, a medium term expenditure framework (MTEF) should be in place prior to HIPC assistance to provide such a baseline. A full-fledged MTEF, a long-term goal of many countries, could include subnational governments, with expenditures classified comprehensively by function and by program. There would also be a clear understanding of the relationship between the MTEF, on the one hand, and intermediate targets and final objectives for poverty reduction, on the other hand. Tracking of the impact of the HIPC Initiative on poverty-related spending would then involve comparing a baseline MTEF, prepared before the receipt of HIPC assistance, with one that includes HIPC assistance.

17. **To complement this comprehensive budget framework, governments should have a timely, credible, and transparent accounting, reporting, and auditing system to monitor and report on the budget outturn.** A Government Financial Management Information System (GFMIS) is an important component of a comprehensive expenditure management system.

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<sup>9</sup> For example, in Guinea-Bissau, poverty-reducing expenditure is projected to increase by over 4 percent of GDP from 1999 to 2002, even though debt service paid is expected to be higher after the HIPC decision point as a result of the regularization of relations with creditors. However, due to increased donor assistance, net inflows after HIPC are projected to double.

18. **Ultimately, tracking of spending should also assess whether the resources spent actually reach the poor and provide them meaningful benefits.** Increased budget allocations to poverty-reducing programs may not have the desired impact on poverty if the funds do not actually reach their intended uses or if the programs are poorly designed or implemented.<sup>10</sup> It is unfortunately quite difficult to establish a straightforward ex ante link between public spending and poverty reduction.<sup>11</sup> Empirical evidence on the relationship between spending on specific categories (such as expenditures on education or health care) and resulting outcomes in terms of social indicators (such as educational attainment and health status) is weak.<sup>12</sup> Both overall budget allocations and the efficiency and targeting of actual spending matter in achieving improvements in the outcomes measured by social indicators.<sup>13</sup>

19. **Therefore, in addition to tracking spending, countries should also monitor the actual delivery and impact of public spending.** Periodic public expenditure tracking surveys can help to identify how funds actually flow in the budget system. These surveys have had a major impact in properly directing the disbursement of education spending to schools in Uganda, for example, and are being implemented as part of World Bank programs (as part of either lending or analytical work) in many other countries. Incidence analysis, drawing on data from household and service delivery surveys, can help identify the impact of government programs.<sup>14</sup> In cases where detailed studies are not available, “quick-and-dirty” incidence analyses can provide useful information.<sup>15</sup> The World Bank will help to evaluate the poverty-reducing impact of country policies in the context of Public Expenditure Reviews (PERs) and other relevant instruments.

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<sup>10</sup> For example, Ablo and Reinikka (1998) discuss a survey of selected primary schools in Uganda that found initially that less than one-third of non-salary expenditures earmarked for primary schools actually reached the intended beneficiaries. This percentage has risen considerably as a result of changes in disbursement procedures adopted in response to the study.

<sup>11</sup> Mechanisms to monitor the impact of social expenditures on poverty typically do not exist in HIPCs. Data on social indicators needed to assess broad poverty trends become available only with a lag of several years, and studies on the benefit incidence of social programs are available only for a limited number of countries and are carried out infrequently.

<sup>12</sup> These findings are reported in several studies. See, for example, Filmer and Pritchett (1997), Flug, Spilimbergo, and Wachtenheim (1998), Landau (1986), Mingat and Tan (1992 and 1998), and Gupta, Verhoeven, and Tiongson (1999).

<sup>13</sup> See, for example, Gupta and Verhoeven (2000).

<sup>14</sup> For a discussion of benefit incidence analysis, see Demery (2000).

<sup>15</sup> For example, a matching of the geographical distribution of expenditures with regional income distribution data (e.g., as derived from poverty maps) can provide a first-cut at the incidence of priority spending. See Devarajan and Hossain (1998).

20. **Most HIPCs do not yet have the necessary budgeting and financial management systems fully in place to track budget execution and to monitor outcomes.** The medium-term objective must be a strong focus on building PEM systems while establishing “bridging” mechanisms to track as much as possible with existing data.

### C. Short-Term Approach

21. **Thus, in the short run, it will be necessary to take a pragmatic approach by building incrementally on existing systems to achieve more effective tracking capacity.** Any such short-term approach must, however, be consistent with overall long-term objectives as outlined above and must provide institutional incentives to continue the process. In the absence of a baseline MTEF, multi-year fiscal scenarios (often developed with the assistance of IMF and World Bank staff) can help in assessing likely patterns of spending. Where no plausible baseline exists, simple “before-after” comparisons can point to planned changes in the spending patterns resulting from HIPC assistance.<sup>16</sup> Staff papers prepared for the Boards of the Bank and the Fund are already reporting such planned shifts in expenditure composition. Subsequently, the composition of overall public spending (both budgeted and actual) would need to be tracked. Over time, this approach to medium-term fiscal forecasting could be developed into a full-fledged MTEF.

22. **Tracking the composition of public spending requires that budget information is comprehensive (capturing, as far as possible, extrabudgetary and subnational operations) and sufficiently detailed to measure shifts in line with poverty goals.** In the short run, comprehensive and disaggregated data on spending may be unavailable, and thus only partial, broad-brushed estimates of central government spending may be feasible. For most countries, the analysis of the shift in the composition of public spending will focus in the first instance on broad categories of spending by function. But functional data often give only an indication of shifts toward general social sectors—such as education or health. They may not identify the pro-poor component within such broad categories. In cases where more disaggregated data are available, developments in spending on basic social services with higher pro-poor incidence (e.g., primary education and basic health care) can also be taken into account.

23. **As indicated earlier, all programs expected to contribute significantly to poverty reduction could be identified and tagged, for example, in a virtual poverty fund.** Items identified for tracking would need to have a potentially significant impact on poverty. A country-owned poverty reduction strategy will normally relate certain expenditures to

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<sup>16</sup> The “before-after” approach should be adjusted for changes in spending patterns that can be foreseen with a large degree of certainty (e.g., due to interest payments on domestic debt already contracted and multiyear capital investment projects). For countries that qualified for HIPC assistance under the original framework (Bolivia, Burkina Faso, Mali, Mozambique, Uganda, Guyana, and Côte d’Ivoire) higher poverty-reducing spending may have already occurred, adding a further complication to assessing the change in the composition of public spending. In such cases, therefore, a point of comparison predating the original HIPC Initiative would have to be established.

intermediate targets (e.g., increasing enrollment in primary schools) and ultimately to poverty reduction objectives (see Box 1). In such cases, it may be possible to tag or code transactions identified as poverty reducing for the purpose of tracking. Where this is not possible, particular poverty-reducing spending can be tracked by requiring appropriate spending units to submit data on these outlays by line item.<sup>17</sup> Budget allocations, as well as outturns, for selected activities can then be tracked to assess the amount and efficiency of poverty-reducing spending.<sup>18</sup> This is feasible in most countries if they make efforts to produce the relevant budget data on a timely basis. As full-fledged PRSPs are prepared, HIPCs may require some assistance to help them align their virtual poverty fund with the poverty-reducing programs identified in their PRSPs.

**24. While virtual poverty funds and before-after comparisons offer a useful intermediate or bridging approach, HIPCs should aim to develop a program classification.** Under this classification, all spending on poverty-reducing activities would be classified by program—even those activities where spending may cut across functional lines (e.g., HIV/AIDS prevention may include expenditures on both health and education). This would provide a more exact basis to assess the impact on the poor of a shift in the composition of public spending. For the few countries with significant poverty-reducing spending by subnational governments, special arrangements may be required.

#### **IV. PUBLIC EXPENDITURE MANAGEMENT SYSTEMS IN 25 HIPCS**

**25. The IMF/World Bank work on assessing the quality of Public Expenditure Management (PEM) systems in HIPCs has had two initial objectives.** The first has been to identify short-term “bridging” mechanisms to enable tracking of poverty-reducing spending using existing budgeting and PEM practices. The second has been to identify and prioritize, both by subject matter and by country, the obstacles to satisfactory tracking and, hence, the capacity-building required to improve budgetary practices and thereby facilitate effective tracking. It should be noted, however, that in some cases the obstacles to satisfactory tracking are related as much to incentives as to capacity. It will be important, therefore, to generate incentives for effective tracking and introduce scrutiny of the tracking process, so as to promote sustainability and reassure the international community that assistance will be effectively used.

**26. In late 2000 a joint World Bank/IMF team undertook preliminary assessments of the quality of central government PEM systems in the 25 countries that have reached, or are expected to reach, the decision point under the HIPC Initiative within**

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<sup>17</sup> However, this indirect way of managing and extracting the data may have an adverse impact on their timeliness and accuracy. In the worst case, the budget line items that include the poverty-related spending would need to be identified and tracked more broadly within the existing budget information system.

<sup>18</sup> These relationships would be expected to be consistent with the overall fiscal framework.

**the next few months.**<sup>19</sup> These were desk assessments only, and the team drew on answers by World Bank and IMF desk economists to 36 questions as well as discussions between the desk economists and PREM and FAD specialists. The answers were supplemented with information available from other sources, such as resident experts in the field or earlier World Bank/IMF work on capacity building. Questions were also asked on potential obstacles to the effective use of future assistance.

27. **The preliminary assessments were designed to identify weaknesses in PEM systems that could hinder the tracking of poverty-reducing public spending, and thereby to begin to prioritize needs in upgrading PEM capacity.** They were not aimed at ranking countries or their practices against one another. In most OECD countries, PEM relies upon computerized Government Financial Management Information Systems (GFMIS), and many have well established Medium Term Expenditure Frameworks (MTEFs). These tools are not generally present in HIPCs, cannot be developed quickly, and were not considered as relevant benchmarks for this exercise. Nor could the assessments directly apply the good practices from the Code on Fiscal Transparency. Although many similar considerations apply, the Code covers a wider range of fiscal management issues and focuses principally on the transparency of institutional arrangements rather than the performance of specific tasks.

28. **To assess relative needs, benchmarks were adopted that describe the basic requirements for a PEM system to track poverty-reducing public spending.** Most benchmarks could, with strong commitment and effort, be achieved within one to three years for some (though not necessarily all) HIPCs. In assessing the quality of PEM systems, basic standards were applied on budget formulation, execution, and reporting. Wherever possible, an objective indicator was applied—for example, whether the reconciliation of fiscal and monetary data is carried out on a routine basis—but a few indicators, such as the quality of internal audit, were inevitably more subjective.

29. **The findings are summarized in terms of 15 key public expenditure management issues as shown in Table 1, which also describes the specific benchmarks adopted for each.** The findings are then grouped into three broad categories—budget formulation, budget execution, and budget reporting. The summary assessments are based on the percentage of benchmarks met for the broad categories of budget formulation, execution, and reporting, and are summarized in scores expressed as: “little upgrading required,” “some upgrading required,” and “substantial upgrading required.”

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<sup>19</sup> The countries are: Benin, Bolivia, Burkina Faso, Cameroon, Chad, Côte d’Ivoire, Ethiopia, The Gambia, Guinea, Guinea-Bissau, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Senegal, Tanzania, Uganda, and Zambia.

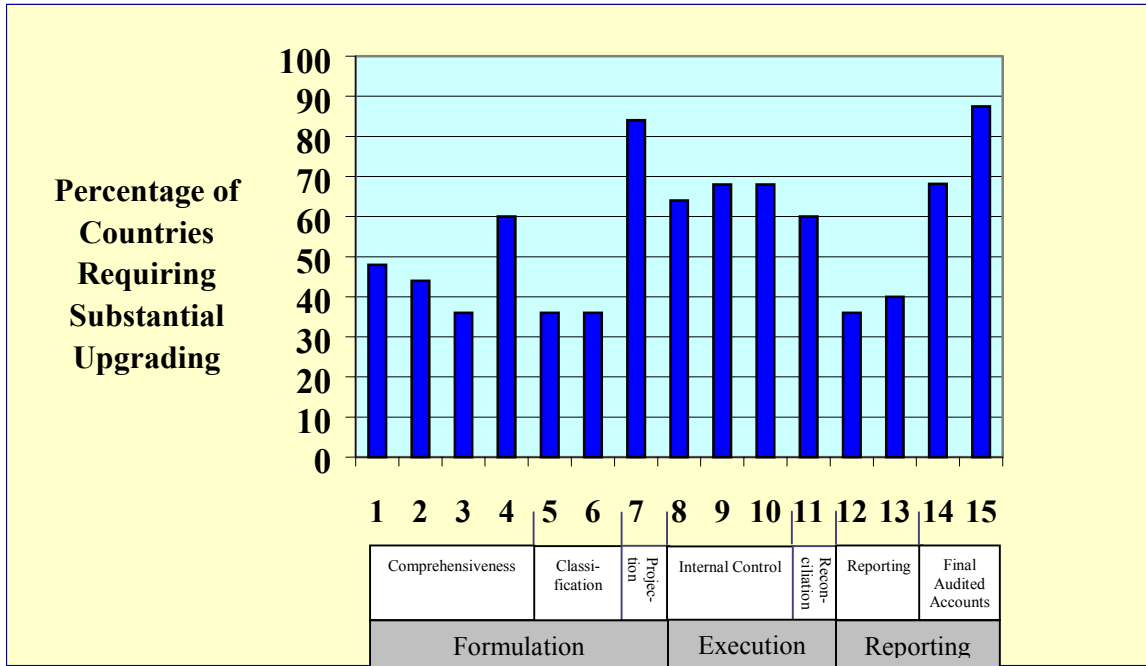
**Table 1. Description of Expenditure Tracking Issues and Benchmarks**

Budget Management		Benchmark Description
Formulation	<b>Comprehensiveness</b>	"Close-fit or better" to GFS definition of general government Extra (or off) budget expenditure is not substantial Level and composition of outturn is "quite close" to budget Both capital and current donor funded expenditures included
	1. Composition of the budget entity	
	2. Limitations to use of off-budget transactions	
	3. Reliability of budget as guide to outturn	
Execution	<b>Classification</b>	Functional and/or program information provided Identified through use of classification system (e.g., a virtual poverty fund)
	5. Classification of budget transactions	
	6. Identification of poverty-reducing expenditure	
	<b>Projection</b>	
Reporting	7. Quality of multi-year expenditure projections	Projections are integrated into budget formulation
	<b>Internal Control</b>	Low-level of arrears accumulated Internal audit function (whether effective or not)
	8. Level of payment arrears	
	9. Quality of internal audit	Tracking used on regular basis
10. Use of tracking surveys		
Reporting	<b>Reconciliation</b>	Reconciliation of fiscal and monetary data carried out on routine basis
	11. Quality of fiscal/banking data reconciliation	
	<b>Reporting</b>	Monthly expenditure reports provided within four weeks of end of month Timely functional reporting derived from classification system
	12. Timeliness of internal budget reports	
	13. Classification used for budget tracking	Accounts closed within two months of year end Audited accounts presented to legislature within one year
<b>Final Audited Accounts</b>		
14. Timeliness of accounts closure		
	15. Timeliness of final audited accounts	

30. **The preliminary assessments summarized in Charts 1 and 2, suggest that the capacity to track public spending varies considerably across countries:** Two HIPCs already have significant capacity to track and report poverty-reducing spending and need only modest upgrading of their present systems. A further 7 countries have made significant strides in recent years but still need further upgrading to achieve this objective. Sixteen HIPCs will require substantial upgrading to meet their goal of tracking poverty-reducing public spending. The specific needs for upgrading vary considerably across countries, and geographical or historical patterns (e.g., between Francophone and Anglophone systems in Africa) cannot be discerned.



**Chart 1. Relative Needs for Upgrading Budgetary Systems**

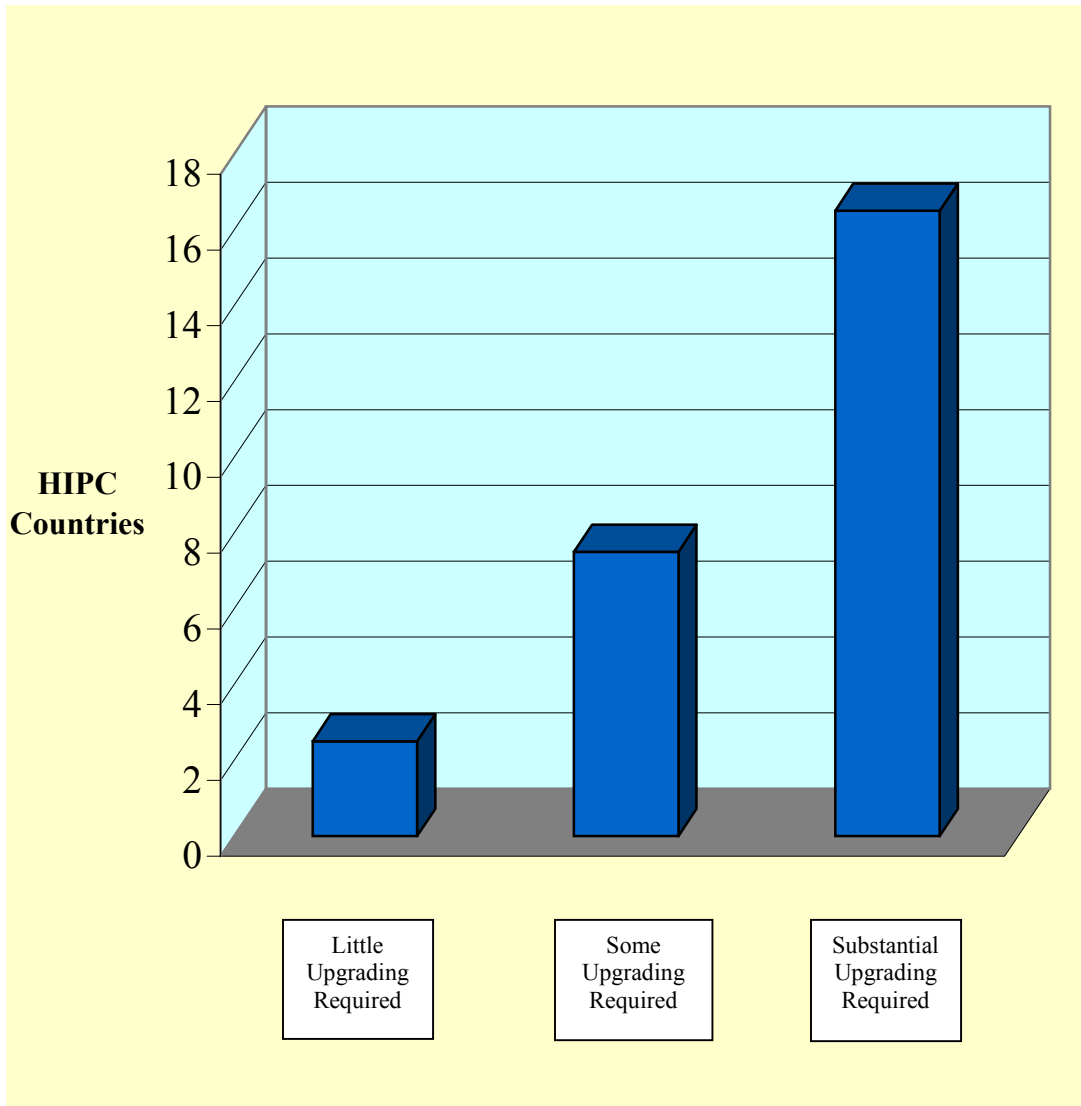


31. **The needs for upgrading are generally recognized by the countries concerned, and are being addressed by them and by donors.** Most HIPC countries that have reached the decision point have completion point triggers or program conditions related to public expenditure management. In other cases, regular reporting by individual countries on improvements in their PEM systems could take place in the context of Article IV consultations, the PRGF and PRSP review process, and PERs. Of the 22 countries that had reached the decision point by end-2000, 16 countries<sup>20</sup> have identified needed improvements in PEM systems covering the broad categories of budget formulation, execution, and reporting, as completion-point triggers. These improvements include:

- Publication of quarterly or semi-annual budget execution reports, particularly of health and education sectors;
- Introduction of an Integrated Financial Management Information System (IFMIS) in pilot ministries;
- Adoption of an MTEF;

<sup>20</sup> The countries are Benin, Cameroon, The Gambia, Guyana, Guinea, Guinea-Bissau, Honduras, Madagascar, Malawi, Mauritania, Mozambique, Nicaragua, Niger, São Tomé and Príncipe, Tanzania, and Zambia.

**Chart 2. Need to Upgrade Systems for Tracking Poverty-Reducing Spending<sup>21</sup>**



<sup>21</sup> It should be stressed again here that these are preliminary results, and they will be refined through discussions with country authorities. The countries are: Benin, Bolivia, Burkina Faso, Cameroon, Chad, Côte d'Ivoire, Ethiopia, The Gambia, Guinea, Guinea-Bissau, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Senegal, Tanzania, Uganda, and Zambia.

- Undertaking tracking surveys and implementing recommendations from these surveys in education and health;
- Placing the programming and execution of foreign-financed capital expenditure under the control of the Ministry of Finance;
- Strengthening control institutions such as the Offices of the Comptroller General and of Administrative Probity; and
- Auditing and publication of contracts.

32. **Moreover, many HIPCs have already taken steps to strengthen their PEM systems in recent years.** Indeed, ongoing work in a number of these countries should significantly improve their capacity to track within the next year. But the capacity of most HIPCs needs to be further substantially upgraded, and institutional incentives will also need to be strengthened in order to promote effective use of assistance and to sustain gains in capacity.

33. **Improved capacity in budget formulation may be less difficult to achieve in the short term,<sup>22</sup> but it may prove ineffective unless accompanied by reforms in budget execution and reporting that are more difficult to achieve.** The results thus suggest that there is a somewhat greater immediate need to focus on budget execution and reporting than on budget formulation. Furthermore, for countries that are implementing many of their poverty-reducing spending programs at state or local government level, upgrading subnational budgetary systems—formulation, execution, and reporting—may be particularly difficult. The detailed findings are summarized in Boxes 2 and 3. In terms of more specific findings:

- **Budget formulation.** For some topics, such as consolidation of budget data and classification, existing practices are amenable to short-term assistance. However, other PEM practices, such as the development of multi-year projections for poverty related and other expenditures, are more difficult.
- **Budget execution.** Capacity building in budget execution systems is likely to need more than technical work. Substantial progress will require a combination of government-wide commitment to improve the transparency and accountability of budget execution procedures, oversight mechanisms, such as parliamentary scrutiny and monitoring by intended beneficiaries, short-term improvements in existing

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<sup>22</sup> Capacity building in budget formulation has been a focus of both IMF and World Bank efforts in HIPCs and other countries in recent years.

### **Box 2. Budget Formulation**

- About half of the 25 HIPCs analyzed have budgets that use an appropriate definition of consolidated general government broadly consistent with GFS standards.
- While extrabudgetary spending is identified for over 40 percent of the HIPCs, in most cases, it is confined to health, social, or pension funds that are well documented and can easily be brought into the central government budget.
- Over one-third of HIPCs have sufficiently detailed data on donor-financed expenditures, and it may be possible to widen coverage of donor-financed current and capital outlays fairly rapidly with better cooperation between donors and governments.
- In about a quarter of HIPCs, more than 10 percent of poverty-reducing spending has been devolved to subnational governments.
- Most countries have already implemented a functional classification of budget plans sufficient to assess intended changes in expenditure patterns. But quality varies, with some reliance on aggregations of high level administrative line items, not on program-related coding.
- Altogether, more than two-thirds of the countries plan to use a virtual poverty fund or other classification-based approach (which can be seen as a form of program classification), to monitor and track some particular set of poverty-reducing programs and projects.
- About half of the HIPCs already use some type of multi-year projections. But these are mostly limited to sector-specific projections that are used for public investment programs. Less than a fifth already have a Medium-Term Expenditure Framework (MTEF) that is fully integrated into the budget process. The remainder of the HIPCs are only now beginning to establish the capacity to produce meaningful medium-term projections.

### **Box 3. Budget Execution and Reporting**

#### **Budget Execution**

- Most HIPCs have budget outturns which are considered quite close to their original budgets, although a sizeable minority (more than one-third) have significant differences between planned and actual expenditures.
- About two-thirds of HIPCs do not have serious payment arrears problems.
- Almost one-fifth of HIPCs have already introduced expenditure tracking surveys that seek to determine the actual use of public money.
- About one-third of HIPCs are reported to have active internal audit systems, but a closer look suggests that for most, internal audit capacity is partial at best, and often ineffective.
- Over one-third of the countries now undertake regular reconciliation between fiscal and monetary accounts.

#### **Budget Reporting**

- In less than a fifth of HIPCs are the audited accounts forwarded to the legislature within twelve months of the end of the fiscal year. In some cases, the accounts are never closed and audited.
- More than one-third of the HIPCs close their books shortly after the end of the fiscal year, which in these cases reduces the scope for discretion in assigning transactions as between fiscal years, which has been a source of some abuses in the past.
- One-fifth of HIPCs provide in-year tracking reports within two weeks of the end-of-period, and two-thirds within two to four weeks. While about two-thirds of HIPCs surveyed provide a functional classification for the budget, over one-third do not currently provide in-year tracking on a functional basis.

manual (non-computerized) procedures, and sizable investment in computerized facilities over the medium term.<sup>23</sup>

- **Reporting.** The most pervasive weaknesses concern budget reporting and an inability to validate reported budget outturns. Again, a high-level commitment to reform will be needed to make progress in this area. But some issues in reporting are amenable to short-term remedial measures, for example, strengthened manual budget reporting systems from line ministries.

## V. STRENGTHENING THE CAPACITY TO TRACK POVERTY-REDUCING SPENDING

34. **The challenge now is to achieve the systemic institutional reform in HIPCs required for the tracking of poverty-reducing spending.** In most HIPCs, it is likely that countries' own efforts will need to be supplemented with external assistance to meet this challenge.

35. Therefore, in considering how PEM capacity can be upgraded, three principles should apply:

- **Most importantly, countries must 'own' their reform program in capacity building.** As noted earlier, PEM systems are critical for strengthening governance. A strong commitment and in-country leadership are essential to achieve progress in PEM reform. Public officials and key decision makers in each HIPC government must have a clear understanding of capacity building needs and incentive structures in domestic institutions. They should participate in, review, discuss, and modify (where appropriate) any in-depth capacity assessments. The demand for assistance in capacity building to meet those needs must come from the country itself. In this context, the capacity building program should build on the internal pressures to strengthen transparency, governance, and accountability in PEM systems, as also reflected in PRSPs. Capacity building will be a collaborative effort that will require agreement between HIPCs and donors on needs and remedies. Responsibility of the country for satisfactory tracking should be set out in PRSPs, PRGFs, and PRSCs, and significant improvements should be expected by the HIPC completion points.
- **Any short-term assistance provided in tracking poverty-reducing spending should be consistent with medium-term development needs.** Real improvement in PEM requires a concerted and sustained commitment to medium-term capacity building. In some cases, short-term actions may have a somewhat different focus, but should still be consistent with medium-term goals. For example, manual systems for budget execution and reporting may need to be bolstered in the near term as a high priority in the context of virtual poverty funds, even while the introduction of

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<sup>23</sup> Examples of this include the development of manual-based commitment control systems, in several cases with technical assistance from the IMF.

computerized information systems and controls that enable greater transparency remain the medium-term goals. This could require an interim period of balancing short- and medium-term requirements.

- **The program of assistance has to be carefully structured to meet the most important needs, to fit the institutional environment, and to be paced to the absorptive capacity of the country.** It is not possible to identify, except on a country-specific basis, which needs have high priority and which interventions are likely to be feasible. It will be important also to ensure that the program of assistance takes account of the starting point from which to absorb and implement new procedures and techniques. The record of past use of donor assistance can help to identify the factors conditioning demand for and capacity to absorb such assistance. Though backward-looking, such an assessment gives an indication of the speed, scope, and quality of absorption of assistance in capacity building, and the extent to which the structure of interests and incentives needs to be altered in order to promote effective use of assistance.

36. **Both the World Bank and the IMF have been active in helping countries strengthen their PEM capacity.** This assistance has expanded particularly rapidly in the past 4 years (see Box 4), and considerable progress has been made in numerous instances. The emphases of the two institutions in this area have been guided by their relative mandates, the IMF's involvement being motivated by the need to strengthen overall macrofiscal management, and the World Bank's by structural and institutional issues related to poverty reduction. Furthermore, their instruments to support PEM reforms are largely complementary, with the IMF providing assistance through focused staff missions and the funding of resident experts, and the World Bank providing assistance through analytic products (see Box 4) and lending for investments in systems upgrading and technical assistance. In some countries, the assistance from the two organizations has led to improvements in budget classification, in the consolidation of central government monies in the central bank as part of the process of developing treasury systems, and in the reporting of budget outcomes. Efforts to help countries develop integrated financial management systems, stronger expenditure commitment controls, MTEFs, and external audit capacity have met with somewhat more mixed results, although substantial progress has been achieved in some instances.

#### **Box 4. World Bank/IMF Ongoing PEM Work**

**The World Bank** has a number of programs and projects in HIPC countries which incorporate elements of capacity building in PEM systems, whether at the center of government (e.g., ministry of finance) or in sectors (e.g., health, transportation). This includes adjustment and technical assistance (TA) loans (e.g., to reform public policies in the expenditure area, to assist in building a MTEF, to introduce external audit and civil society monitoring, or to finance and oversee the installation of computerized information systems) and Economic and Sector Work (ESW) such as Public Expenditure Reviews (PERs), often with related public expenditure tracking or incidence surveys; Country Financial Accountability Assessments (CFAAs); Country Procurement Assessment Reviews (CPARs); and Institutional and Governance Reviews (IGRs). In the aggregate, approximately \$3 billion of the World Bank's adjustment lending in both FY99 and FY00 contained conditions regarding public expenditure management reform, and about \$250 million of investment lending in each year was designed to provide TA in public expenditure management. About 20 to 30 PERs, CFAAs, and CPARs each are completed annually. The public expenditure tracking survey (PETS), a relatively new World Bank analytic instrument, is particularly appropriate for addressing some short-term HIPC expenditure tracking issues. Five PETSs were recently undertaken in 4 countries, with more planned in several HIPC countries. Their detailed implementation can be adjusted to give more priority to reforms that will enable tracking of poverty-reducing spending. In particular, the new Poverty Reduction Strategy Credits (PRSCs) can target specific aspects of the PEM process.

**IMF** technical assistance has been delivered through a combination of missions and resident or peripatetic experts. From 1995–2000, FAD undertook 20 such missions, all of which provided reports to countries setting out recommendations for reforms. In addition, over this period, there were between 4 and 9 resident advisors in these countries. Currently, the IMF has a total of 8 resident PEM experts in HIPC countries, whose terms of reference can be adjusted to include some of the changes required to ensure satisfactory tracking. IMF TA, including work to strengthen tracking capacity, can be provided as follow-up to completion of the fiscal module of the Reports on Observance of Standards and Codes (ROSC): 8 such ROSCs are planned in HIPC countries over the next 6 months.

**The World Bank and the IMF** should also build on regional efforts directed at strengthening PEM capacity, such as implementation of budget classification standards mandated by the West African Economic and Monetary Union (UEMOA).



37. **Over time, both the Bank and the Fund have increasingly recognized the need for appropriate domestic incentives, commitment on the part of the authorities, and a realistic time frame.** As noted earlier, PEM reform is not merely a technical challenge but is also a complex governance challenge, and it requires commitment and persistence on the part of country authorities and technical assistance providers alike.<sup>24</sup> In moving forward, the two organizations will continue to work together to strengthen the complementarity of their work to meet the needs of HIPC.

38. **The task immediately ahead for the World Bank and IMF is to continue to deepen the dialogue with country authorities, both to improve the accuracy and to strengthen country ownership of the preliminary assessments made by the two staffs, and to define possible country assistance programs in light of the revised assessments.** This will be carried out by IMF/World Bank country teams, regional or central sector specialists, and in some cases, staff teams that visit HIPC on other travel. Country-specific action plans will be drawn up for upgrading capacity to track expenditures. These action plans should be core components of PRSPs and reflect commitments under PRGFs, PRSCs, CASS, and other negotiated instruments. Country by country, they should establish a trajectory with realistic intermediate steps. Such incremental steps should be consistent with the medium-term objective of putting in place strong PEM systems.<sup>25</sup>

39. **Some parts of this country assistance program can be delivered by adjustments, with the authorities' agreement, to ongoing IMF/World Bank work in capacity building.** In making these adjustments to ongoing PEM work, IMF and World Bank staff will seek to make full use of missions already planned in this area.

40. **Coordination between the World Bank and the IMF and other creditors and donors is also required to meet the demand of countries' for capacity building.** Collaboration between potential providers of assistance in capacity building has already begun. In particular, the EU and the World Bank are discussing the possibility of a special Trust Fund to fund assessments, define realistic benchmarks, and formulate action plans for capacity building in the area of PEM, with IMF participation on the Trust Fund Board. Several bilateral donors have also indicated a willingness to be involved in this work. Both the World Bank and the IMF are considering what further mechanisms may be set up to ensure effective coordination of efforts. Systematic coordination with the donor community on a country basis, using the resident IMF/World Bank staff to monitor ongoing relevant work, can ensure that duplication is avoided and objectives are achieved efficiently.

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<sup>24</sup> For further discussion of lessons of experience in assisting countries with governance reforms, see World Bank 2000a.

<sup>25</sup> As noted earlier, this strengthening could include improved budget classification; provision of more disaggregated expenditure outturn data by function in the social sectors to help identify spending that is pro-poor (for example, outlays for preventive health care); accelerated reporting of above-the-line (but unaudited) expenditure data; and new procedures for reconciling above- and below-the-line data.

41. **However, the weaknesses indicated by the preliminary findings suggest that the program of assistance may need to be significantly augmented, which would entail considerable additional resource requirements.** Generating additional support, including from other multilateral organizations and the donor community, will be critical if a more ambitious program of analysis and support is to be realized. The proposal for a multi-donor Trust Fund noted above can help in this regard, and other mechanisms may also need to be considered.

42. **In allocating limited resources for PEM work, the World Bank and IMF will take into account the following criteria, to be applied in a flexible manner:**

- the extent to which PEM capacity needs to be upgraded;
- the likelihood that the assistance will be put to good use, reflected in part by the track record in the use of past assistance and absorptive capacity;
- the degree to which the World Bank and IMF have existing lending or TA operations in the country, and the extent to which tracking poverty-related spending reinforces (or is reinforced by) other work in the country on PEM (e.g., ROSCs, fiscal transparency assessments, Public Expenditure Reviews, Country Financial Accountability Assessments); and
- the extent to which the country is receiving assistance from other donors, both multilateral and bilateral.

43. **The World Bank will continue to assist countries through its lending and analytical work depending on specific country needs, country absorptive capacity, and available resources.** While the range of World Bank work in public expenditure analysis and management will remain broad, specific assistance to any particular country will be defined through the Country Assistance Strategy (CAS), which articulates the specific program of lending and ESW adapted to the needs of the country. The World Bank's staff and budget resources<sup>26</sup> have been sufficient for the degree of involvement so far, more resources will need to be devoted to this work in the FY02 budget if country demand increases on the scale identified by the preliminary assessments. Some of the increase in resources can be achieved through a redeployment of existing staff, but expertise in some specialized areas will need to be added to the existing skill base through the hiring of 2–4 additional PEM experts (either staff or consultants).

44. **IMF TA will continue to be provided through both missions and the assignment of resident experts.** The IMF will focus on ensuring proper classification of poverty

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<sup>26</sup> The World Bank's Public Expenditure Thematic Group numbers approximately 200, spread among the 6 regional vice-presidencies, PREM, DEC, WBI, and OED, although not all focus on public expenditure issues in their current work. Financial management experts in the Operational and Core Services network assist countries through CPARs and CFAAs.

programs, and short-term improvements to provide timely and accurate accounting and reporting of spending on these programs. The extent of the demand for FAD TA will only become clear once assessments are finalized, action plans prepared, and the contribution of other donors to this effort is known. In the meanwhile, FAD will need to allocate 4–5 person years in CY2001 to assist country authorities in finalizing PEM assessments and action plans.

45. **The country assessments and assistance programs will be reevaluated periodically.** IMF and World Bank staff can provide periodic reports to their respective Executive Boards describing progress, work plans, and any further actions. The first report is expected to be provided by the end of this year, at the latest. This report will focus on the steps required to address weaknesses in the PEM system over the short- to medium-term; and on the assistance that has been provided and that will be required.

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