

# Chapter 1

## WHAT IS THE EXISTING BUDGET EXECUTION STAGE AND HOW DOES IT FIT INTO 'PUBLIC EXPENDITURE MANAGEMENT' (PEM)<sup>2</sup>?

### 1. Definition of the Existing Budget Execution Stage (BES)

Budget of Expenditures and Sources of Financing (2001) or BESF defined the term budget as “an estimated schedule of expenditures, based on either obligations or cash concepts, and sources of financing, either from revenues, borrowings or cash balance drawdowns. Ministry of Budget Operations Manual (1979) defined BES and explained its essence in the following manner:

*“The third major step of the budget process is budget execution. Budget execution consists of the activities necessary to place the approved budget in operation. Under this major step of the budget process, plans and policies in the use of appropriated public funds and budgetary controls necessary are adopted to ensure that the effective, efficient, and economical utilization of government resource are put into force.”*

*“Under this phase, the budget serves as a tool for fiscal and management controls. Fiscal control – in such a way that expenditures are controlled to adequately result in the optimum performance kept within the limits of available resources. Management control – in the sense that it is used in the attainment of desired goals in the most economical and efficient utilization of public funds.”*

The aforesaid manual has assumed that spending rules and controls can ensure effective and efficient resource allocation.

### 2. How Does the Existing BES Fit Into PEM?

Although having the same ends, the existing BES and PEM differ in their means.

#### 2.1 Same Ends

Budget execution supports the attainment of the results expected from PEM: (a) control expenditures within the limits of available resources (aggregate fiscal discipline); (b) enable line entities' optimum performance in the attainment of desired goals; and, (c) economical and efficient utilization of public funds (operational efficiency).

In simple terms, PEM prescribes the following: (a) spend within affordable limit (domestic revenues plus a sustainable level of domestic and foreign borrowings<sup>3</sup>/cash balance drawdown), (b) spend on the right things (focus budget on MFOs), and (c) get

a good/best deal for what one spends (value for money).

A government that is efficient in an allocative sense will likely attain its desired outcomes. (In other words, allocative efficiency is necessary but not sufficient in outcome attainment. There may be uncontrollable factors that affect the attainment of outcomes.) PEM is not meant to lay-off many government officials/personnel. Excess manpower will be dealt with through attrition<sup>4</sup>. Operational or technical efficiency refers to the provision of a public service at a reasonable quality and cost.

## **2.2 A Digression: A Strategic Perspective in the Choice of Means to Attain Ends**

### 2.2.1 An Anecdote: In Search of 'Rudder' Solutions

It may be noted that the long-term effective solutions to problems are not usually the obvious solutions as could be gleaned from this anecdote. During the olden times when the first vessel was being designed, the problem was how to make the first vessel turn left or right. A person suggested that another vessel be used to push the front part of the first vessel. However, the second vessel cannot turn itself. Another person proposed to tie a rope to the front part of the first vessel. But who will pull the rope in the middle of the sea?

Since the problem was in front of the vessel, everyone was looking for a solution that was in the same location. The vessel was big, so everyone then was looking for a big solution. Lastly, everyone was looking for a quick-fix solution, something that will make the vessel turn abruptly to the left or to the right.

For many years no such solution was identified, until someone thought of a rudder which has been the long-term effective solution. The problem was in front of the vessel but the effective solution was at the back. The problem was big, but the solution was small. Everyone was looking for a quick-fix, but the rudder makes the vessel turn slowly to the right or to the left.

### 2.2.2 Long-Term Effective Solutions may not be 'Located Where the Problem Is'

To improve allocative and operational efficiency in government, the long-term effective or rudder solution is not for DBM to institute detailed line item control of inputs but to (a) set performance indicators (PIs) related to MFO quality and limiting unit MFO cost and (b) providing incentives (consequences) for failing to attain PIs. These are the 'rudder solutions'. This is the reason for the incentive-based approach of PEM.

### 2.2.3 Long-Term Effective Solutions may not be 'Big'

During the seventies when zero-based budgeting (ZBB)<sup>5</sup> was introduced, the budget forms were very elaborate and detailed leading to thick documents (i.e., 'big'). The budget forms in PEM should ideally have much less details since the idea is to encourage line secretaries to focus resources to MFOs while having a transparent formula for baseline calculation. This approach would lead to thinner documents (i.e., 'not big').

## 2.2.4 Long-Term Effective Solutions may not Provide Quick Fixes

The improvement in allocative and operational efficiency in PEM may be expected, not immediately, but after all the necessary components (identification of appropriate PIs consistent with the organizational performance indicator framework (OPIF) incorporated in the 2001 and 2002 Budget Calls, improving the institutional capacity of the Commission on Audit (COA) to audit performance data and associated systems, cascading down OPIF to the performance of units and personnel in line entities, and linking performance to consequences, among others) are in place. This could easily take at least five years<sup>6</sup>.

## 2.3 **Different Means**

PEM differs from the existing BES (subsequently referred to as prior system) in the means to attain the ends in Subsection 2.1.

### 2.3.1 PEM's Focus on Desired Outcomes and Prior System's Lip Service to the Same

PEM focuses on desired outcomes (including client satisfaction) and outputs/strategic processes linked to these outcomes. The outcome-oriented outputs serving external clients or MFOs guide the determination of budget details. PEM encourages line entities to undertake non-budget intensive policy reforms that are critical to outcome attainment.

Page 33 (Subsections 3.1.2 and 3.1.4) of the Ministry of Budget Operations Manual or MBOM (1979) states:

*"3.1.2 Presidential Decree (PD) No. 1177 requires that all agencies prepare their budgets on a performance basis stressing 'socioeconomic development plan and shall be oriented towards the achievement of explicit objectives and expected results to ensure that funds are utilized and operations are conducted effectively, economically, and efficiently.'"*

*"3.1.4 The Revised Budget Act defines 'expected results' as the delineation of the services and products, or benefits that will accrue to the public, together with the estimated unit cost of each type of service, and product or benefit."*

While the past framework intended to orient programs/projects towards results or outcomes, the implementation of that framework with a focus on 'physical performance' was not consistent with the intention.

2.3.1.1 *Prior System's Emphasis on Legal Basis as Against PEM's -- Consideration of the Same as Enabling Rather Than Mandatory.* In the prior system, virtually<sup>7</sup> all the expenditure implications of the existing legal framework are considered high priority. PEM emphasizes the results that an organization aims to achieve from the provision of outputs.

That result must be consistent with or embraced by the mission which an organization has to accomplish. The mission could be as stated in the law creating the organization. If that mission has lost its relevance in the context of globalization and other policy environmental changes, then the law providing for that mission should be interpreted as

enabling, rather than mandatory. In other words, a mission is not necessarily a mandate

2.3.1.2 *PEM's Focus on MFOs and Prior System's Emphasis on UWMs* -- A good budget in PEM supports the production of major final outputs (MFOs), which by definition are linked to outcome attainment. The past system regarded a good budget as one with a detailed specification of units of work measurement (UWMs) which include intermediate and final as well as minor and major outputs. It also emphasizes budgetary compliance with detailed and rigid rules, not effectiveness or outcome attainment.

2.3.1.3 *Broader Concept of Accountability in PEM* -- Line entity's accountability in PEM is broader. It encompasses (a) the attainment of controllable outcomes (including client satisfaction), (b) production of major final outputs, (c) undertaking of strategic/important processes critical to outcome attainment, and (d) limiting of expenditures to budgeted amounts. (The use of process indicators is on a highly selective basis.) Accountability in the past system is in terms of physical and financial performance and compliance with rules. Both systems encourage agencies to limit unit cost to a standard, thereby promoting efficiency.

### 2.3.2 Controls of Output Costs in PEM and Input Costs in the Prior System

It may be noted that there are differences between output price, output cost, and input cost.

2.3.2.1 *The Market Concept of Output Price as the Net Present Value of an Individual's Net Benefits from Output Consumption: A Digression* – The operation of the free market mechanism enables arms-length exchanges between producers and consumers at mutually agreed prices that reflect the latter's expected outcome (present value of an expected stream of annual benefits net of costs, say from the consumption of educational services) arising from the consumption of outputs. When a parent sends his child to a private school, the parent is purchasing an educational service and an expected outcome is that given the good quality of teaching, the child will be able to find employment and earn in the future. (The parent would be oblivious of the costs<sup>8</sup> of inputs purchased by the school.)

#### 2.3.2.2 *Output Cost Control in PEM* –

2.3.2.2.1 *Output Cost Control in PEM in the Longer Run* – In PEM over the longer run, input costs will be classified into fixed and variable in relation to the production of final outputs under a full accrual accounting framework<sup>9</sup>. Unit cost (with appropriate adjustment for any difference in accounting standards and/or predicament, as in the case of different operating scale) will be benchmarked to that of efficient and effective similar organizations worldwide. In this case, output unit cost is equal to output price minus profits<sup>10</sup> in an accounting sense.

In the coming few years (under the existing accounting system), direct current operating expenditures (COE) associated with the production of an MFO will be aggregated. Direct COE cost per unit of MFO will be benchmarked on a similar basis if possible.

#### 2.3.2.2.2 *Output Cost Control in PEM in the Short Run* –

2.3.2.2.1 Formula-based Approach in Setting Baseline Expenditures – In almost all cases, benchmark data may not be available in the short run. The formula-based calculation of baseline in the 2002 Budget Call will be used. (At this stage, aggregate costs without MFO breakdowns are calculated.) By definition, baseline expenditures are supposed to yield the same level of MFO quantity as in the immediately preceding year and have a decline in purchasing capacity<sup>11</sup>. This means that the line entities are forced to be more efficient.

2.3.2.2.2 Flexibility to Line Department Secretaries in the Baseline Allocation to Various Inputs – While OPIF limits PIs to MFOs (exclude indicators on minor outputs), line department secretaries are given the flexibility to allocate baseline to various agencies and inputs that will lead to the attainment of the PIs.

2.3.2.3 Input Cost Control in the Prior System –

The prior budget system relied heavily on detailed line item expenditures<sup>12</sup> or budget input controls (DBM's intervention in controlling details of staffing modifications, position reclassifications, equipment purchases, and other individual expenditure items) purportedly to attain operational efficiency. Input control is equated to safeguarding taxpayers money from inefficient use, judged on the basis of compliance with procedures. There is only a tangential regard for 'expected results'.<sup>13</sup>

2.3.2.3.1 Certain Successes and an Example of Large Economic Cost of 'Backfires' of Input Cost Control – Under this system, there were certain successes. For instance, in terms of the size relative to population, the Philippine government bureaucracy appears to have just about the right number of personnel notwithstanding anecdotal evidences of overstaffing in certain agencies.<sup>14</sup>

In 1987, the author as an Assistant Secretary of DBM adjusted the Department of Education, Culture, and Sports' (DECS) proposed unit cost of carpentry tool kits (based on canvass of retail prices) from P5,000 per kit to P1,500. (Each kit has about 50 items including nails and screws of different sizes.) In 2000, the Corporate Operating Budget of the Light Rail Transit Authority (LRTA) may have led to savings of about P5,000 in the unit price of a sofa, but may have economic costs from the country's perspective amounting to millions of pesos as the economic life of light rail vehicles (LRVs) is reduced with DBM's prescription to reduce supplies/materials which include spare parts.

2.3.2.3.2 Detailed Input-Related Rules have a Tendency to Simplify and Neglect the Complex Nuances of Reality – Many detailed input rules have a tendency to simplify and neglect the complex nuances of reality. The lease contracts of labor attaches' offices of the Department of Labor and Employment (DOLE) in Middle East countries require rental advances of 6 months or in some cases 1 year. Thus, a general rule of equal monthly cash allocation would fail to consider this reality.

Another input related rule is that inventory of supplies and materials should not exceed one quarter requirement. While this may be alright for domestic purchases, the same rule would be detrimental to imported spare parts (which may not be 'off-the-shelf') for expensive equipment like LRVs. (The setting of appropriate inventory level should consider leads for reordering, parts manufacturing, and transportation from abroad.)

2.3.2.3.3 Input Controls Contribute to Delays in MFO Production – In view of the time required for DBM to control inputs (like analysis of proposed changes in staffing patterns), the production of MFOs by line entities is delayed.

2.3.2.3.4 Dilution of Line Entities' Accountability – Input control is not a long-term effective solution to operational inefficiency since agencies' accountability is diluted. It has always been the case that line entities would blame DBM for delayed releases or actions on proposals for staffing modifications, position reclassification, and others in case they do not attain their agencies' goals. The system of line item input controls enable line entities to escape accountability.

### 2.3.3 PEM Assumes that Line Department Officials/Personnel are 'Capable Angels'

PEM assumes that line department officials/personnel are 'capable angels'. It therefore (a) provides an environment that enables department/ agency executives to attain desired outcomes and (b) prescribes the institutionalization of future performance incentives/consequences. PEM recognizes that the application of the full force of the law against corrupt officials/personnel (in lieu of DBM prescribing many, rigid, and detailed rules) is effective in minimizing corruption.<sup>15</sup> In the past system, DBM had primary responsibility and authority for making detailed budget allocations and correspondingly diluted the accountability of agencies. In PEM, DBM does not control the allocation of budget to detailed items but encourages line entities to concentrate funds to final outputs (including associated PAPs) linked to outcomes.

## **3. The Important Concerns of Allocative/Operational Efficiencies and Effectiveness in the Philippine Context**

Allocative efficiency relates to effectiveness in the sense of maximizing outcome per output while operational efficiency is associated with maximizing output per input (including expenditures).

### **3.1 *The Importance of SEER in Reviewing the Linkage of Final Outputs to Outcomes***

As earlier stated, it has been assumed in the past that all PAPs in the GAA and the legal bases of departments will lead to the production of final outputs linked to outcomes. Through the SEER process, a "soul searching" by a line entity is encouraged with the assistance of the National Economic and Development Authority (NEDA) and DBM to render a judgment on final output-outcome linkages on the basis of (a) good practices abroad in terms of sector intervention mechanisms, (b) logical framework analysis, and (c) existing studies.

### **3.2 *Formulation of Long-term Ideal Organizational Frameworks as One of the Prerequisites for Addressing Excess Personnel of a Number Line Entities***

If one compares the ratio of government personnel to population among countries, it would appear that there is no overstaffing in the Philippines. (One way of interpreting this is that most governments worldwide are overstaffed.) However, when one benchmarks certain entities (like COA as earlier stated in a footnote) with that of other countries, it is clear that there is overstaffing in the Philippines. This viewpoint could be

complemented if one visits a regular agency where a significant number of personnel are not doing much.

Consistent with SEER, it is necessary to formulate ideal long-term organizational frameworks as bases for addressing the excess personnel problem. (The savings could obviously be channeled to poverty-alleviating programs.) A department secretary may be given the option later on to implement the said framework either on an attrition basis or some other means.

### **3.3 *Service Quality Suffers Given Agency Resource Inadequacies*<sup>16</sup> *Compounded by Corruption-Related Leakages***

The Need to Require Department/Agency Heads to (a) Cascade Down OPIF and Tie with Incentives and (b) File Administrative Cases When there are Evidences of Corruption

#### **3.3.1 A Digression to Illustrate that the Major Problem is to Maximize Service Quality (Including Outcome Attainment) Given Inadequate Resources**

3.3.1.1 *High Performance in the Midst of Resource Inadequacies of a Specific School – Robbed* (1999) cited the Guiuan National High School in Eastern Samar which placed tenth in the average 1997 achievement test scores of virtually all students (both in government and private schools) in Region VIII despite the fact that the aforesaid school's first class would graduate in mid-1999. Yet, a significant number of the students in that school were attending classes under the trees without chairs and tables! The aforesaid book attributed the school's success despite the odds of input shortages to good administration/management by the principal and teachers' work commitment (perhaps out of a sense of higher level mission to make a difference for the country).

3.3.1.2 *Accrued Expense Per Student in DECS Schools is Less than 70% that in Private Schools Medium-Term Expenditure Framework – Focus on Proposed Guidelines in the Preparation and Use of Forward Estimates in the Philippines* (1999) roughly estimated the accrual equivalent of DECS financial statements and found out that accrued expense per student in DECS schools is less than 70% that in private schools.

The average achievement test score in DECS' high schools was about 80% that of the private sector in 1998.

#### **3.3.2 Another Problem is How to Minimize the Leakages**

Assuming hypothetically that there was corruption in input procurement in the aforesaid Ozamis City school (as maybe gleaned from an adverse COA audit finding), the problem is not how to clean the baseline budget because clearly the school lacks resources. (In this context, the application of a targeted efficiency improvement rate may be uncalled for.)

The problem is how to minimize the leakage.

### 3.3.3 The Importance of Immediately Cascading Down OPIF

Very few government personnel would have the commitment of the principal/teachers in the aforesaid Ozamis City school who rendered extraordinarily effective teaching services in the virtual absence of positive and negative incentives and in the midst of severe resource input inadequacies. Most personnel would only act in the same manner if incentives exist.

Thus, it is very important from the perspective of maximizing service quality in the midst of resource inadequacies to improve the system for evaluating the performance of units within agencies and their personnel to ensure that the same is consistent with OPIF. Once this is done, it is necessary to apply the civil service regulation that two consecutive unsatisfactory performance ratings should lead to separation from service.

## **4. Interconnectedness of BES and Other Stages of Budgeting**

It should be noted that budget execution is deeply intertwined with budget preparation, legislation, and accountability stages. For instance, consistent with PEM, it makes sense to have more aggregative expenditure items (along MFO lines). If this done, then there will be more agency spending flexibility during budget execution.

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<sup>2</sup> PEM is a public-sector-resource-allocation system that (a) gives reasonable assurance that new expenditures approved for a budget year can be funded over the medium-term (three years in the Philippine budgeting context at present) and (b) accords priority to expenditures that are oriented towards achieving desired outcomes. In PEM, only outcome-oriented new expenditures that are financially sustainable over the medium-term are approved.

Desired outcomes are ultimate societal outcomes and/or intermediate sector/sub-sector/organizational outcomes. Ultimate societal outcomes refer to (a) lower poverty incidence and other indicators on the attainment of missions in the Medium Term Philippine Development Plan and (b) welfare status like human development index (HDI) which incorporates life expectancy, functional literacy, and average family income. It may be noted that HDI data are available from the National Census and Statistics Office (NCSO).

In particular, PEM asks the following questions: (a) “What are the desired outcomes?” and (b) “What final outputs, processes, and budgets are required to achieve these outcomes?” Further, PEM also encourages government organizations to undertake strategic outcome-oriented activities which require small or no budgets at all.

<sup>3</sup> The International Monetary Fund’s (IMF) standards for presentation of government finance statistics prescribes the presentation of borrowings on a net basis (gross minus repayment of principal). Net financing is equal to net borrowings plus net cash balance drawdown.

<sup>4</sup> Different from PEM, the Reengineering the Bureaucracy for Better Governance (RBBG) program allows a department secretary to deal with the problem of excess personnel through less subtle means. A line department secretary will decide the approach (PEM or otherwise) to be employed in dealing with the aforesaid problem. It

should be noted that the following are early activities which are common to both PEM and RBBG: (a) identification of appropriate intervention mechanisms in a sector and (b) formulation of ideal long-term organizational frameworks.

<sup>5</sup> In PEM, ZBB analysis may still be undertaken, not by DBM but by the line entities.

<sup>6</sup> It may be noted that Malaysia has a seven-year program to institute a performance management system.

<sup>7</sup> An exception in 1987 was the following. The author as Director of the Government Corporate Budget Bureau considered as enabling (not mandatory), the Philippine National Railway's (PNR) charter that specified a certain annual amount to be appropriated as equity in the General Appropriations Act (GAA). In perhaps 99% of the cases in the past, legally provided expenditures have been considered mandatory, not enabling.

<sup>8</sup> The independent determination of output price and input costs in the market encourages producers to be efficient. (Otherwise, producers tend to maximize inputs under a socialist economy where prices are centrally determined and are equated to accounting costs.)

<sup>9</sup> In this case, indirect cost like general administration and support services (GASS) will be allocated among the final outputs using an allocation base (like number of direct personnel).

<sup>10</sup> For economists, this is equal to the imputed interest earnings on shareholders' capital plus 'consumer surplus'.

<sup>11</sup> In concept, this decline is a targeted efficiency improvement (called 'efficiency dividend' in Australia), a mechanism which would not require DBM to examine the 'reasonableness' of input costs. This is the case because, given a baseline with declining purchasing capacity, an agency is suppose to produce the same quantity and quality of MFO as in the immediately preceding period. (It may be argued that without the efficiency dividend, DBM should examine the unit cost of inputs as a means of contributing to the attainment of operational efficiency. Of course, as a highly unusual exception, DBM may decide to review the cost of inputs that account for at least say P500,000,000. If this is done, then the DBM-determined input cost could be an input in the calculation of an indicative standard MFO unit cost. Then, the line entities will be allowed on the final input cost allocation while maintaining the total MFO cost determined by DBM.)

<sup>12</sup> In the vernacular language, a division chief in the operating bureaus of DBM during the prior system would usually say to his/her subordinates "*Busisiin o kutuhan mo yung budget ng line agency.*" Manuel (2001) stated that up to two years ago, the concept of unit of work measurement (UWM) was still used during budget preparation.

<sup>13</sup> Ministry of Budget's Operations Manual or MBOM (1979) defined expected results as the "delineation of the services and products, or benefits that will accrue to the public, together with the estimated unit cost of each type of service, and product or benefit."

<sup>14</sup> This may mean that almost all bureaucracies worldwide are bloated in terms of personnel. (Please refer to the Medium-Term Philippine Development Plan 1999-2004 for data on inter-country comparisons of the ratios of government personnel to population.)

For instance, COA has about 13,000 personnel. Its counterpart in developing countries in general have 6,000 to 8,000 personnel while that in Australia has less than 2,000. Another example is that the University of the Philippines has a ratio of non-teaching to teaching personnel of 2:1.

<sup>15</sup> PEM does not advocate the cutting of budgets of departments with corrupt officials, because doing so will (a) penalize an agency's clientele, not the corrupt officials/personnel and (b) not reduce corruption propensity. If a department has adverse COA audit findings on overpricing of supplies, the budget will not be reduced by the extent of overpricing if the department head files administrative cases against corrupt officials/personnel and if the MFO quality is not acceptable (i.e., as judged by clientele or in reference to operating standards). PEM tries to treat corruption as an issue separate from resource allocation considerations. PEM focuses on the linkage of final outputs to desired outcomes as the major consideration in budgeting.

Similarly, under-performing personnel are treated in the same way as corrupt personnel. In the longer run, giving unsatisfactory performance rating to these personnel for two consecutive periods would complement the filing of cases in dealing with the aforesaid issue, since the personnel could be removed from government service.

<sup>16</sup> It appears that line agencies generally lack resources for maintenance and other operating expenditures (MOOE) and capital outlays (CO).

***(End of Chapter 1)***

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