

**DRAFT**

**ASSESSMENT OF PROGRAM BUDGET  
AND RELATED BUDGET REFORMS**

**KOREA**

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## **Introduction**

1. Government reform often fails because it is poorly implemented. The design may be sound, but if its purposes are not clearly understood, or if stakeholders view it as a threat or burden, reform will wither. To succeed, reformers must win over those who produce information, provide services, and manage bureaus and agencies. The fate of reform rests in their hands, not in those of the small band of innovators who sit at the center of government, but are organizationally and politically distant from line managers and rank and file employees. In modern times, reform must be consultative and participatory, taking account of the motives and incentives of those whose careers may be changed by new systems and procedures. These stakeholders have to be drawn into the reform process, they must understand its logic and aims, and they must comprehend why change is desirable. Reforming government is hard work, for it requires both leadership and partnership, people in charge determined to alter the machinery of government, yet open to those who will be impacted by the changes.
2. This chapter assesses the manner in which the Government has introduced program budgeting, MTEF and related reforms. It does not purport to provide a full or balanced assessment; it concentrates instead on those features that may need adjustment and slights those that appear to be working well. Inasmuch as the reform enterprise is still in its early stages, the assessment is tentative. But the fact that reform is in its infancy provides greater scope for influencing the

- direction it will take. It is better to offer advice on a reform strategy that has not yet fully unfolded than to offer a post-mortem on a reform whose ambitions have been thwarted.
3. Section 1 focuses on technical aspects of reform, in particular, the objectives and design of various features. Section 2 deals with the implementation strategy, the manner in which proposed changes have been portrayed. The overall assessment is favorable. Establishment of BARO and the commitment of significant resources to develop new systems and practices demonstrate the Government's determination to modernize both the budget process and underlying financial management systems. The architecture of reform, discussed in a previous chapter, shows that due consideration has been given to the way various sub-processes connect with one another. MPB has signaled its willingness to divest various ex ante controls, thereby broadening the operating discretion of spending agencies. It also wants to lengthen the time horizon of budgeting, strengthen fiscal constraints, make the budget into a key instrument of government policy, and expand the use of performance indicators. Yet, there also are some disquieting signs, such as the concentration on reform activity in MPB and BARO, inadequate engagement of line ministries and other stakeholders, excessive concentration on budget classification, and inadequate explanation of reform objectives and strategies. If the community of reformers is not broadened, many line managers will view the initiatives as new instruments of central control or as

- paperwork exercises that add to their work burdens, not as opportunities to improve the efficiency of public expenditure.
4. A reform program that is as ambitious as Korea's cannot be managed or implemented from the center alone. The Government must have committed allies; if it doesn't, it will most certainly have powerful adversaries instead. It is essential, therefore, for MPB and BARO to actively enlist other central agencies and line ministries in the reform process – consulting them before key decisions are made, being sensitive to their concerns, and using their expertise and experience to improve the reform strategy and build support for it.

## **I. The Machinery of Reform**

5. Budget reform in Korea has many parts. While they have been designed to cohere in an integrated framework, it would be useful to examine each part separately and to note issues that may arise as the reform program advances. The discussion begins with program budgeting because it has received much early attention and because, as explained in the “architecture” chapter, is the principal means of linking the budget and accounting structures. Implementation of the reform agenda is dependent on replacing the input-based budget and accounting

structures with a program structure. How program budgeting is designed and introduced will affect other budget reforms.

6. **Program budgeting should be an enabler of better resource allocation, not just a technical change in the way budget data are classified.** Program budgeting in Korea has two principal aims: to base budget allocations on the purposes and objectives of government; and to give line managers greater operating freedom by reducing the approximately 6000 items in the current budget structure to a more manageable number. These aims generally reinforce one another; both can be pursued through a new program structure. But they do pull design of the program structure in somewhat different directions. Orienting the budget to objectives dictates that the program structure transcends organizational boundaries; giving managers operating flexibility requires that the program structure keep within these boundaries. Orienting the budget to government objectives entails much more than arranging expenditures within a program structure. It anticipates that the program structure will shed light on how well government is accomplishing its stated objectives, and open the door to robust assessment of existing programs and policy options. Giving managers operating freedom is a much simpler task, for it merely requires that existing controls be terminated by broadening the scope of budget items.

7. It appears that Korea has given higher priority to operating flexibility than to policy development. For one thing, it has decided that programs should be within organizational boundaries; for another, in the early stages of devising a new budget classification, it has focused on the number of items and levels of control. There is as yet little evidence of a deep reconsideration of government objectives. This may come in due course, but there is a great probability that it will be shunted aside by other reform activities. In some quarters, classification is viewed as an end in itself, not as a building block for far-reaching changes in fiscal management.
  
8. Aligning program and organizational structures may be necessary to simplify the task of devising a program structure, compiling data by programs, and winning acceptance of the new arrangement. But it is possible that the congruence of organizational units and program categories will descend down the program structure, to the bureau level or even lower. It is quite common for governments to build a program structure in which the label “program” really refers to discrete organizational units. For example, the Bureau of Air Quality Control is relabeled the Air Quality Control Program. When this occurs, the program structure adds little value, except for the broadened administrative discretion given managers. To guard against the program structure becoming simply a new set of budget labels, the Government should consider the following suggestions:

- a. Use the sectoral structure to link programs across ministries;
  - b. Ignore bureau boundaries in defining programs;
  - c. Separate development of the program structure from BARO's work on the accounting system.
9. The sectors should be treated as a means of aggregating programs across ministries. They should not be instruments of budget control. As noted in the Architecture Chapter, the sectors should be the organizing structure for fiscal management planning. This is envisioned as the process by which the Government will set national policies and develop policy initiatives. In defining priorities and policies, the Government's focus should be on national objectives, not on the particulars of administrative operations. Although we have not examined the current sectoral structure, it probably is in need of some revision. This will not be a difficult technical task, though there may be some political sensitivities. Our understanding is that salaries and other personnel expenses are classified as a separate sector. In order for sectors to be a useful classification, it is essential that these costs be allocated among the sectors they serve.
10. To emphasize a point made earlier, the sectoral classification should not be regarded as an instrument of budget control. Each program should be coded to the sector it contributes to, but budget allocations should be by organizational unit and program, not by sector. The sectoral classification will have two related

- purposes in the new budget framework: to structure the policy planning process and to facilitate the evaluation of programs and policy options.
11. There is no ideal sectoral or program classification. Strong arguments can be made, for example, to classify city streets as transportation or urban development programs. All programs that serve multiple purposes have multiple potential classifications. Health clinics in schools contribute both to the education mission of government and to the health of children. Fighting over which is the better classification, as occurs in many countries that implement a program structure, would be an arid exercise; it would be preferable, instead, to devise a pliable accounting and budget structure that recognizes the multiple objectives of government activities.
  12. A program structure adds little value if expenditures are not accounted for by program. It is essential, therefore, that special accounts and public funds be consolidated in the program structure, preferably by terminating these accounts and funds, or if this is not feasible, by coding them according to the programs they contribute to. If the latter option were taken, some programs would be financed by multiple sources: general and special accounts, and possibly public funds.
  13. It also is essential to allocate costs by program, so that each program recognizes all the direct costs related to its activities. Cost allocation can be done through a

variety of methods, and without installing a complete cost accounting system. Direct costs should be allocated even when they are budgeted to (or incurred by) an organizational unit other than the one responsible for the program.

14. The program structure is intended to enlarge managerial flexibility, but whether it accomplishes this will depend on how programs are defined and the amount of detail and number of levels in the structure. The approach recommended here is to have a fairly flat program structure consisting of only four levels (5 when subprograms are specified for programs having multiple objectives, or operated by multiple organizations.) Level 1 would be the ministry or agency; level 2 the program; level 3 activities, and level 4 major expenditure elements (personal services, other operating expenditures, investment, subsidies, and transfers). The key issue is likely to be the manner in which activities are accounted for. In defining activities, the Government has to balance the need for managerial operating freedom against the Legislature's (and the public's) demand for information. Good management would dictate that the program structure have less detail; good politics might dictate that it have more. If the Government opts for less detail, it is possible that program budgeting will be attacked as a scheme to deprive legislators and citizens of information that they had in the traditional budget system. In some countries, the government has sought to deal with this problem by publishing the new program budget along with the old line item structure. When this is done, program budgeting is almost certainly doomed to

failure. In Korea, the problem is exacerbated by the strained relationship between the Government and the National Assembly. One possible solution would be for the Government to provide additional “activity” detail in supporting documents that are not part of the budget control structure.

15. **Top-Down Budgeting must be a process for giving policy guidance to ministries.**

Top-down budgeting has been launched in a faulty manner. One shortcoming is that the ceilings have been MPB dicta and have not been sufficiently based on consultation within Government or on bilateral discussions with spending ministries. A second problem is that the ceilings have been bereft of policy guidance. A third serious defect is that without linkage to an ongoing fiscal management process, the ceilings may be interpreted by spending units as floors, thereby generating upward pressure on future budgets. Finally, the initial round of ceilings appears to have stirred much confusion in spending units. Some of these problems derive from the way top-down budgeting has been implemented, some from the inevitable tension that comes from restructuring budget rules and relationships.

16. In the first round of top-down budgeting, for the 2005 budget, MPB set a ceiling on each ministry’s budget request, as well as target ceilings for each of the next four years. Not surprisingly, ministries are confused as to whether they are free to allocate funds within the ceilings as they deem fit. Inasmuch as MPB is (and

- should be) interested in how available funds are to be distributed among the many budget elements, it has given mixed messages to ministries, suggesting that they have more discretion but conducting the same budget reviews as it did in the past.
17. The main source of trouble has been the premature initiation of top-down budgeting. It is one thing to give ministries spending ceilings for the next budget cycle; this has been done in many countries that use traditional budget formats. But it is quite another to provide multiyear frames before critical elements of the MTEF are in place. The Government cannot transmit policy guidance to spending units before the fiscal management plan is operational; it cannot provide sub-ceilings for programs before it has a program structure. Ideally, top-down budgeting should mean that the Government has formulated key policies that guide budget preparation in line ministries. These policies communicate priorities for the next year and the medium-term, and indicate the programs that should receive additional funding and (sometimes) those that should be trimmed.
  18. The Government views top-down budgeting as a necessary step to constrain the incessant rise in public spending as a share of GDP. But it may have unwittingly opened the door to future spending increases by setting each year's ceiling above the previous year's. One should not be surprised if opportunistic politicians and managers use the out year ceilings to build support for future spending increases above those planned by the Government. For this reason, it may be prudent for

- the Government to issue ceilings only for the next year rather than for the next 4-5 years until such time as the MTEF is fully implemented.
19. There is no simple answer to the question whether a single ceiling should be given for each ministry. In view of past practices and the Government's development plans, it would be sensible to disaggregate ministerial ceilings by programs. These program allocations should be the principal instrument for communicating the Government's policies to spending entities. Of course, these program sub-ceilings depend on implementation of a program structure.
  20. When ceilings cover several years beyond the budget year, it is essential that Government have the capacity to measure the impact of policy changes on future budgets. The chief contemporary instrument for calculating these impacts is the baseline (for forward estimates). Because Korea's fiscal planning system looks five years ahead, but is not rolled forward, MPB has not invested in constructing a baseline. Nevertheless, MPB should be mindful of how spending units might behave when they are assigned medium-term budget constraints. Some are likely to propose policy initiatives that have modest spending impact in the next year but grow into expensive commitments in subsequent years. Baselines can discourage this type of budgetary legerdemain by making future costs more transparent. In countries that have adopted MTEF, the baseline is not merely a projection of future budget conditions. It is an authoritative statement of approved government

policy, measured in budgetary terms. By definition, therefore, any deviation from the baseline represents a change in policy. A well-functioning baseline contains the assumptions and methodology for measuring policy changes and estimating their impacts on future budgets. Korea's lack of a baseline means that this estimation capacity has not yet been built into the routines of budgeting.

21. ***The relationship of the annual budget and the fiscal management plan in the MTEF should be clearly defined.*** As just explained, the baseline connects the annual budget and future plans. The absence of a baseline severs this link and renders it possible that the budget will be disconnected from medium-term decisions. If this were to occur, Korea would make separate decisions through the budget and the MTEF processes. Inevitably, the budget decisions would supersede the medium-term plans. Rather than the plan being the starting point for budget work, the budget would be made anew, each year, without reference to the plan.
  
22. Integration of budgeting and planning might be facilitated by putting the fiscal management plan on a rolling basis. This would have the effect of making the budget the first year of the plan; it would not be a separate decision process. A rolling plan would encourage the Government to focus each year's budget decisions on policy changes, as measured against the baseline. While this approach would be a retreat from comprehensive planning, it might generate more

- policy change than would support a process that purports to review all spending decisions every year. A rolling plan does require that the Government maintain a baseline; otherwise, it would lack the capacity to project future budget impacts.
23. A rolling plan, in which the first year is the annual budget, which focuses on changes to the baseline, would recognize the inherent incrementalism of budgeting. While this might appear to be a backward step, no budget reform that has tried to uproot incrementalism has succeeded. In fact, countries that have successfully introduced MTEF generally have been able to make larger policy changes than they did in conventional budgeting. One explanation for this pattern is that MTEF usually is accompanied by other changes in budget practice that give politicians and ministers greater scope to reallocate resources within their budgets.
24. Regardless of whether it shifts to a rolling NFMP, MPB should clarify the purposes and procedures of the fiscal management plan. At present, the plan is little more than a label and an aspiration. To become operational, it is essential that MPB spell out how medium-term plans will feed into annual budgets, as well as the timing of actions, the roles and relationships of participants, the types of information to be produced, the decisions to be taken, and other characteristics that make up a planning-budgeting process. It is especially important that fiscal policy be only one dimension of medium-term planning. The planning process

should be used to make – and change – substantive policy; if it isn't, the process will forego its main opportunity to influence the budget.

25. **The performance measurement system (PMS) should be deployed to sensitize politicians and managers to the results of public expenditure.** MPB is still pondering the design of PMS, and key decisions lie ahead. Some decisions relate to the types of indicators, but these are secondary to the larger question of how the new performance information will be used. MPB seems undecided on two questions: the extent to which performance information should be published; and whether this information should be formally linked to the budget. These issues have to be resolved before Korea can effectively launch PMS. If line managers do not have a clear sense of how performance information will be used, they may assume that it will be used against them – to cut their budgets and programs – and they will react accordingly. No performance management system can succeed if managers do not have a clear understanding of how the information generated by it will be used, or if they believe it will adversely affect their interests. PMS, like other efforts to orient public management to performance is utterly dependent on the support of managers. They are the ones who produce the needed information, and they have a keener understanding of actual performance than those at the center of government.

26. The program budget envisioned for Korea would fit well with PMS. Ideally, outcome-type measures would be associated with programs, and outputs with activities. However, MPB seems unsure of how closely PMS and budgeting should be linked. Fusing the two together would likely stir up anxiety in managerial ranks that the new system will arm MPB with new tools for trimming their budgets; separating the two might lead to performance indicators that are not applied. Indeed, the most common fate of performance information is that results are measured, but the additional information is not used in allocating resources or defining programs.
  
27. In deciding on its course of action, MPB should consider the approach taken by countries that have effective performance management systems. These systems have several characteristics that may be relevant for Korea. First, performance information aids in budgeting and other decisions, but is not tightly coupled to the level of expenditure. In no government is each increment in resources explicitly correlated with an increment in results. Performance indicators inform budget decisions; they do not dictate the amount allocated. Second, targeting performance in advance can be a powerful influence on the behavior of spending agencies. It is essential that the targets be selective, that is, that they be few in number, and that they be published. Third, comparing actual results against targets can spur managerial improvement or a realignment of programs.

28. *PMS (and other budget reforms) can succeed only if managers are given substantial freedom in using resources and in operation of their agencies.* All the reforms under development pertain to fiscal management. This framework is unduly narrow; if it is not broadened, there is a strong probability that reform will wither. Broadening has to occur on two fronts. First, significantly more attention has to be given to execution of the budget; second, reforms has to reach to the overall structure of public management, including personnel systems, the recruitment and behavior of managers, and the accountability regime.
29. The present budget execution system is geared to restrict the spending freedom of line ministries. Not only are they controlled by the items and sub-items in the budget, but they also are governed by quarterly commitment allotments issued by MPB and monthly payment allotments regulated by MOFE. This dual allotment system generates friction between spending units and central controllers, leads to manipulation and evasions, and drives out consideration of performance. What matters to spenders is having enough money to make it though the next month or quarter, not whether they are on track to produce planned results. At the very least, MOFE should switch to quarterly allotments; if feasible, it should terminate these cash controls except in time of grave financial stress.
30. It appears that MBP has not settled on the extent to which items and sub-items will purged from the new budget framework. Although it is agreed that

itemization should be reduced, one senses reluctance on the part of MPB to let go. There is an expectation that this issue will be resolved by introducing a program structure. It might not, for all it takes to retain the current degree of control is to attach items and sub-items to the lowest rung of the program structure. The Government has to make a politically sensitive decision independent of the program structure and determine which controls it will keep and which it will divest.

31. Shifting the focus of budgeting away from ex ante controls is important for a number of reasons. First, as long as budget preparation is preoccupied with inputs, it will not be feasible to focus it on national objectives and policies. Making the budget into a policy rather than a control process is the fundamental aim of the MTEF framework. This aim cannot be achieved as long as budget rules induce controllers in MPB and spenders in line ministries to bicker over the amounts that should be available for supplies, salaries and other items. Second, excessive itemization and centralized spending control impair the capacity of managers to operate efficiently. The driving concept behind most contemporary public management reform is that managers must be free to manage in order to produce results. That is, managers must have flexibility to deploy resources as they deem fit. If they lack this freedom, they might comply with the rules, but they will not perform well. Finally, shifting the basis of budget decisions from ex ante controls to ex ante performance targets is a prerequisite for holding managers accountable

- for what they accomplish with public money. Managers cannot be responsible for failure to perform if they lack the freedom to perform.
32. Shifting the basis of budget decisions and control is a necessary but not a sufficient condition for reorienting public management. It is also essential to recast the culture, organization and other resources and behavior or management so that it is primed to perform well. The evidence from half a century of failed budget reforms around the world is that budgeting cannot be transformed if the larger managerial framework within which budgets are made and executed is not also transformed. Budgeting cannot be based on performance, if management is not. It is erroneous to expect that a reformed budget process will drive changes in organizational culture and behavior. The reverse is more likely to occur. When public management is inattentive to results, performance-based budget reforms will wither. Countries that have experienced the most advanced budget reform are those that have restructured public management.
33. This reasoning leads to the conclusion that public reform in Korea has to be significantly broadened well beyond the budget and accounting structures. Arguably, the most urgent task is to bring human resource management within the ambit of reform. It may also be appropriate to review organizational structures and responsibilities, bureaucratic rules and controls, the way various administrative tasks are carried out, the delivery of public services, and modes of

accountability. We do not have enough information on current management practices to recommend specific steps for improving performance, but it is important that these be considered by BARO or some other agency.

## **II. Implementing Program Budgeting and Related Reforms**

34. Not only is it necessary to expand the scope of reform, it is equally important to expand the ranks of reformers. Even if BARO and MPB were to frame reform only in terms of budgeting and related practices, the cast of participants is much too narrow. At the end of the day, new rules and procedures will have to be implemented by managers who are beholden to their particular sectoral and organizational interests. If program budgeting and other initiatives appear to be alien or burdensome, they will sabotage the reforms and doom them to failure. These people and the organizations must be drawn into the change process at an early stage; it will be too late to do so after key decisions have been made.
35. The BARO meetings during our August mission left us with a strong impression that these were the first times that senior managers in line ministries had interacted with MBO counterparts. Line managers are confused about the new top-down ceilings, do not know what PMS is intended to do, and do not know

- how programs are to be defined or how the program structure will be used. All this spells downstream trouble for the reforms.
36. There are many ways to engage line ministries and agencies. One approach might be to establish an interagency task force to guide the reforms; another would be to establish an internal advisory committee for BARO. But the most direct way is likely to be the best, and that is to consult with managers before key critical procedures are devised. Consultation is especially critical in defining programs and designing the program structure. Line managers are much better positioned than those in central agencies to know who is served by particular programs, how various activities are related, the aims they serve, which performance indicators make sense, and so on.
37. Ministries and agencies differ in the extent to which they are receptive to change. They also differ in the quality of leadership, information systems, management controls, organizational culture, and other variables that have a direct bearing on their capacity to reform. In view of these differences, it would be appropriate for reformers to proceed cautiously. Rather than blanketing the entire Government with new processes, they should proceed on a case by case basis, assessing each ministry or agency to gauge its openness to, and preparedness for, reform. A piecemeal approach differs in one fundamental way from pilot tests. Pilots are prudent when the Government is unsure of the direction it wants to move in, or

- when it does not know how novel systems will work in practice. Piecemeal reform is sensible when the Government is sure about its aims and confident in the new processes, but lacks buy-in (commitment) from all ministries. In our view, the elements of Korea's reforms are neither experimental nor untested. They are not particularly difficult to install once they have been properly designed. There is no need for pilot testing that would take years to complete, consume valuable resources, and leave ministries unsure of the Government's assurance as to its course of action. The typical fate of pilots is that support and interest fade away long before testing has been completed. When the test results become available, the reform agenda has already moved on to other matters.
38. Moreover, several critical elements of the overall reform strategy cannot be pilot tested: they have to be the means by which the Government operates. It is not workable, for example, to impose top-down ceilings on some ministries, but not on others, or to introduce new accounting systems for only part of the Government. MTEF is a framework for all of government, not just for some of its parts. PMS is the only key element that can be tested on a pilot basis. It may be sensible to build experience and confidence in performance measures by trying them out in selected agencies. But even here, pilots are not needed to determine whether outputs or outcomes can be measured. They surely can. But, the key question is how to apply these indicators in allocating and controlling resources.

39. In contrast to pilots, a piecemeal approach is warranted because some entities are primed for new public management and others are not. The two main variables are the openness of leaders and organizational culture to change; and the quality of internal management systems. Because program budgeting will expand the operating discretion of spending units, it is very important that flexibility be granted only to those entities that can use it responsibly. In assessing whether a particular entity is a good candidate for new, flexible public management, it is necessary to assess its internal controls, that is, the system by which it manages itself. Only entities that already have suitable internal controls are good candidates for self-management. This assessment should be made on an agency by agency basis, perhaps applying tools such as the “hurdles” approach introduced in Thailand. This approach evaluates an agency’s capacity against accepted standards. Although Thailand was not successful in applying “hurdles” tests, a modified version of the one used, with more reasonable standards, might work well in Korea.
40. The important thing is not to treat all spending entities alike. Program budgeting should be introduced across the board, but the extent to which budgetary and administrative controls are withdrawn should depend on an agency by agency assessment of capacity and willingness to reform.

41. In moving to restructure public budgeting and management, MPB should consider conducting a survey of management practices and attitudes. It should have a good understanding of the behavior of public managers, how they regard existing rules and procedures, the incentives they have, and their concept of public service. Twenty years ago, Australia launched its far-reaching reforms pursuant to a “diagnostic study of management.” The study provided valuable insights into the perspectives and actions of civil services and enabled the government to base reform on strong evidence of pathologies in the existing system. The diagnostic study also conveyed to managers the message that they would have a voice in the new systems; it made them active participants in the reform process.
  
42. To build consensus for reform, it is especially important that central agencies coordinate their activities. Thus far, MOFE appears to have had a limited role. Its views and voice are especially important in designing the new accounting structure, for it will directly impact on MFE’s treasury functions. MOFE’s cooperation is also important to assure that changes in preparation of the budget are congruent with the manner in which the budget is executed. As already mentioned, it would be desirable for MOFE to shift from monthly allotments to a longer time frame; it may also be appropriate to loosen allotment control of items and sub-items. The Government cannot move toward the accrual basis without support from MOFE.

43. BARO has the lead role in the design of new budget and accounting systems, but there has been a proliferation of *ad hoc* and advisory units in recent years, including the Presidential Committee on Government Renovation. The division of responsibility among the various groups should be clarified, and it may be advisable to consolidate some of the groups. It may also be desirable to separate work on the accounting structure from development of a new budget system. One reason for separating the two tasks is that designing IFIS will be a technically demanding chore; another is to avoid having the needs of the informational and accounting systems dictate design of the budget system. Policy aspects of budgeting (involving macro-budgetary projections, national fiscal planning, top-down budgeting, PMS and the annual budget) require different skills and perspectives than those necessary for accounting and IT tasks. If two groups were created, they would have to work closely together on program budgeting because it connects the policy processes of planning and budgeting with the informational processes of accounting.