CHAPTER TWO

1. Background

The Modified Budgeting System was first proposed by the CFTC consultant to the Government in late 1980's after a period of intense study of the existing budgetting system then in use. After initially encountering fierce criticism from within the Treasury fraternity as well as some selected agencies, MBS was finally accepted as an improved version of the PPBS in Malaysia. In fact the modifications under MBS represents a possible approach to implement the final phase of PPBS ie. monitoring and evaluation phase.

Since its inception, MBS has proven to be more pragmatic and "friendlier" to implementing agencies. There were many radical concepts that emerged from this package of budgetary reforms although some of the ideas were not new in that they had been floated before or were simply not taken up seriously such as determining an early allocation quantum for each operating agency to avoid the many wasteful paperwork and requirements to put up efficiency and effectiveness indicators in every annual Treasury budget call circulars.

This package of reforms was first implemented on a pilot basis in the Ministry of Health, Ministry of Welfare and Ministry of Public Works in 1989 after some intense discussions and preparations on the part of these agencies together with the Treasury and the CFTC consultant. The 3 ministries were chosen on the
strength of their advanced PPBS implementation and they also represented agencies with diverse operating size. The Government went on to implement MBS on a nation-wide basis in these agencies beginning in 1990 without waiting for any post-pilot evaluation. This showed that the Government was already committed to implement the system without waiting for the feedback from the pilot project.

The package of reforms first proposed by the consultant included very wide ranging powers to be gradually devolved to implementing agencies with Treasury's role being reduced to being a mere watchdog and the guardian of very important decision regarding operating expenditures. The modifications to the budget process was primarily aimed at decentralising most of the budgetary powers to Controlling Officers of the respective agencies who would then be held accountable and responsible for the performance of the ministry via a pre-determined set of performance targets.

However, there were initial opposition to the various proposals by the CFTC consultant especially on the question of virement powers, which under the previous system was highly constrained and inflexible. The system, as it existed before MBS, requires the agencies to submit virement applications to the Treasury whenever funds needed to be shifted between Activities and Programs. This virement exercise can be a exasperating especially if an agency has many
Programs/Activities and funds must be shifted across a broad number of general objects and Activities at the close of the financial year. Therefore central to the package of modifications was the proposal to devolve most of the virement powers at central level to those agencies who were then supposed to further devolve these flexibilities down to the lower line managers wherever possible.

Together with the virement bait, agencies were supposed to implement a most radical reform of the budgeting process departing away from the traditional line item emphasis towards performance accountability since the system rested on two fundamental principals, that is, first, managers nearest to where output are produced should be given as much flexibility as possible; and secondly, authority must match accountability. All the modifications were therefore geared towards liberalising the budgetary constraints to increase budgetary flexibility and mobility within an agency and at the same time increased performance accountability on the part of agency.

The proposed modifications were also introduced mainly because the Government’s current budgeting system (PPBS) was unable to place emphasis on allocation-performance linkage and the emphasis had continued to rest on line item details. Most agencies have already some form of performance indicators in their annual budget documents especially indicators on effectiveness and efficiency, but these were either not utilised for purposes of budget allocation or
the agencies themselves do not see any importance attached to these indicators for management control purposes. Moreover, there were no incentives to link accountability and performance with the budget since agencies had very limited budgetary powers. The modifications can therefore be seen as a reaction to this deadlock and to counter any negative impression that the operating budget was a yearly incremental exercise.

While the implementation of PPBS had made the budget process more rational by enabling it to focus on Programs and Activities, as well as on the items of expenditure, there remains shortcomings in the previous system that the modifications were intended to address. These shortcomings as they existed prior to MBS implementation were:

(i) Operating agencies continue to inflate their budget bids in the expectation that these will be cut back. It is this deliberate inflating of budget that has given the budget process the attributes of poker game.

(ii) By inflating budget request for all Programs and Activities most operating agencies were conveniently shifting to Treasury budget officers, the responsibility for prioritising allocation within the Activities and Programs. As a result many top managers in operating agencies continue to be disinterested in budget preparation. The same can also be said of managers at line-management levels where the responsibility for prioritising allocation were left very much to agency HQ budget officers.
(iii) While information on output and on issues of effectiveness and efficiency had been requested in budget call circulars for many years before, yet very little information has ever been provided by operating agencies. Even when they were provided in the budget very little was made to link the performance indicators to the budget request.

(iv) The critical focus of budget examination continues to be on expenditure inputs and not on the results or impact of a particular Activity or Program. As a result discussion during budget examination were heavily concentrated on an incremental expenditure basis.

(v) Many operating agencies remain unconvinced of the uses to which impact or performance information can be linked to the budget process since the mentality of Treasury budget officers was that of cut and trim to ensure the budget recommended was reasonable compared with previous years expenditure and within the means afforded by the Government.

2. Package of Budgetary Reforms

2.1 Expenditure Target (ET)

The ET is a tentative budget allocation for each ministry for its existing policies and services. This figure is normally given approximately 12 months before the new year begins so that ministries and agencies under them can plan and budget their existing policies and services in line with the allocation given. This ET is not the final budgetary allocation since ministries are allowed to apply for additional
funds under the new policy and one-offs categories plus any reductions in policy downscaling or adjustments. The ET is normally estimated by Treasury budget officials and generally should not be less than previous years ET for existing policies and they should incorporate previous year’s new policies as well since by the next budget year these would become part of the existing policies.

The ET for each implementing agency is actually derived mathematically using previous years allocation (adjusted for any non-recurring or one-off payments) as the starting point. This is then adjusted by an anticipated inflation factor (determined by Treasury) and reduced by an expected efficiency improvement factor, usually a nominal percent. The formula for ET is as follows:

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\text{Existing Policy} = \text{Previous Year's Allocation} + \text{Expected Inflation} - \text{Efficiency Dividend}
\]

This reduction for improved efficiency is therefore an allocation ‘sinking lid’ (gradual decrease) on existing activities carried out. However, Emolument allocation are exempted from these inflation and efficiency factors and are determined by different factors. The rational for using previous year’s allocation as the starting point instead of previous year’s expenditure, is to reduce pressure on agencies to spend 100% of their allocation and therefore avoid agencies going on a “Christmas Shopping” spree.

The benefits of introducing an ET include:
o Eliminate "poker game" syndrome inherent in the previous budget system;

o Better budgetary discipline on agencies by forcing them to decide priorities and trade-offs within an overall budget constraint;

o Divert attention away from input (allocation) towards output ie examination now centres on performances; and

o Opportunity for agencies to adopt a top-down approach instead of the previous bottom-up approach. By doing so it eliminates the need to prepare inflated budget submissions.

2.2 Program Agreements (PA) and Exceptions Report (ER)

The Program Agreement (PA) is an annual budget document that sets forth the objectives, requirements and target output for each Activity under a Program. Among the types of information found in a typical PA include its source of authority, objectives, policy analysis and needs, target clients, functions, resources, output specifications, impact indicators and program evaluation plan. This document replaces the usual budget line item document under the old system. Information on budget allocation are now aggregated at general objects level and detailed objects are dispensed with.

An important section found in the PA is the performance measurement where output and impact indicators are listed and their past, current and expected targets are enumerated. These indicators are generally divided into quantitative
outputs, qualitative outputs, timeliness and cost. Most Government agencies implementing MBS would only confine their output indicators initially to quantitative information as it is the easiest to collect and collate while information on quality and cost are very sketchy. As a supplementary system to MBS, the Government has introduced the Micro Accounting System (MAS) to cost the output. The MAS is very much in its infancy stage having started only in 1995.

Under MBS, budget examination would be closely related to examining the output indicators for the new budget year vis-a-vis the expenditure target. The agreed output targets are then given a variance factor whereby for a certain range of output achievement, there is no need to put up exceptions report. This variance usually range between 5% to 15% depending on the type of output indicators and degree of uncertainty in performance.

Whatever the shortfall or over-achievement, the system requires the respective agencies to explain these inconsistencies via Exceptions Reports (ER). These reports are post budget events where the actual performance are matched against the original planned targets and any deviations outside the variance range must be explained. These ER would provide the trigger for agencies to take the necessary steps to address any emerging problems and the conduct of more in-depth and specific evaluations.
The main benefits of introducing such an approach is that:

- It provides a more explicit role for information on performance of each Activity in the budget process and a catalyst for future development of such information;
- Provides a basis for monitoring outputs;
- Provides a basis on which agencies and their managers can be made more accountable for their performance;
- Assists in early identification of potential problem areas and enable early preventive measures to be taken.

2.3 New Policy & One-offs (NPOO)

The NPOO is another modification under MBS although in the past it has been lumped together as part and parcel of the overall budget submission. By officially separating new policy requirements from previous years budget, the Government was in fact giving recognition to the fact that agencies are constrained by operating allocation when implementing new policies and a new vigour should be incorporated to enable agencies to implement new programs with better resources and commitment. The NPOO was therefore a departure from the traditional system in the sense agencies can now bid for more funds as a separate exercise from budgets of their existing Programs and Activities.
However there is a spanner on new policy approvals since under the new system a "threshold" concept is introduced whenever new policies are approved. The threshold works to reduce the new policy allocation by a fixed amount for every one new policy approved. Suppose an agency wants to implement a new program that requires an allocation of RM3 million in the first year then the amount approved would be subjected to a threshold (deduction) but the Government would still insist that the agency be accountable for the planned output and impact as if it had expended the full amount. Fortunately, the threshold is a discretionary authority meaning that for certain new policies the threshold requirement may be waived by the Treasury. Of course some ethical issues would come into play such as the actual monitoring of the RM3 million and the impact of the new program since figures can be easily manipulated to give the impression that the program has achieved certain targets and so much was expended.

Allocation for NPOO are issued separately in the form of block allocation for each approved new policy/one-offs, thereby limiting agencies to spend these funds on new policies/one-offs only and not diverted to other areas. If a new policy is not implemented as scheduled, the allocation given cannot be spent and the Treasury's approval has to be obtained before virement can be made to utilise the allocation for other purposes.
2.4 More Generalised Approach to Expenditure Control

A key element in the MBS reforms is the implementation of a more generalised approach to budgeting. Previously, the expenditure control approach was very rigid since agencies were only able to manipulate their allocation within very limited range and most virements requires the approval of the Treasury. This problem can be monumental if an agency has many Programs and Activities in their structure. This inflexibility can give managers a difficult time when it comes to sourcing for additional funds from other Activities with surplus as well to ensure the timely arrival of such funds since the virement process can take some time.

With this approach, control would be placed at aggregate levels and there would be progressive rationalisation or removal of detailed control. Under MBS, the Treasury regulates an agency's operating budget at Program levels which means that an agency's controlling officer now has more authority to move funds without the need for prior approval of the Treasury. This it is suggested has greatly increased an agency's budgetary flexibility and therefore there is room for improvement in operational efficiency and effectiveness.

With this approach, a distinction has to be drawn between control points and information points. The former refers to the limits of authority an agency or ministry is granted. If an agency wishes to exceed these limits it must seek prior permission from the Treasury. These controls as discussed in the paragraph
above involves movement of funds from one Program to another within an agency. Under no circumstances is the agency allowed to exceed this authority without prior permission from the Treasury.

By contrast an information point refers to information that must be reported. For example, information on allocation of funds by Activities under a particular Program as well as by general objects of expenditure. This is merely to facilitate information communication to Treasury officials who may be interested to know how funds are prioritised within a certain Program.

The benefits of a more generalised approach include:

- significant saving of time and reduction of bureaucratic red tape in the application, processing and approval of specific virement
- greater incentives for managers at agency and implementation level to seek out an optimal mix of resources to improve program performance;
- consistent with the gradual rationalisation and devolution of authority to agencies to match accountability of performance.

2.5 Cycle Of Program Evaluation

The purpose of this reform is to make program performance a dynamic exercise. It is intended to raise awareness among agencies of existing issues that may need to be addressed in the future or to make certain programs more important while
giving others lesser prominence depending on the nature of their services. Program Agreement evaluation is therefore vital in many ways since there could be new information that must be reflected in a program agreement as the years go by or some of the performance indicators have outlived its usefulness and new indicators substituted. Moreover certain PA/Activities may be reviewed with the intention of downscaling or even to merge with other existing PA/Activities to produce a more coherent one or there could be a need to further expand a particular PA/Activity.

Since evaluation requires a thorough review of existing PA/Activity and could even interfere in the daily work, these adjustments for further improvements are made once in several years. Since evaluation by its very nature requires a review of the past to make proposals for the future, this major exercise requires maturity on the part of implementing agency to review its original MBS mechanism. Because of the nature of review, program evaluation can only be conducted over an extended period of time, perhaps after 4 to 6 years from the initial implementation. Assuming an in-depth evaluation is conducted, an agency can at best review a few PA/Activities in a year. In effect, each PA would therefore only be reviewed once in a 4 to 6 years cycle depending on the number of PA/Activities within an agency. For example, if an agency has 40 Activities, and assuming on average 6 Activities were reviewed annually, it would still take about 6 to 7 years to go one cycle of evaluation.
It has been noted that this formal cycle of program evaluation was introduced to gain feedback into the budget process as Treasury is constantly making annual adjustments to each agency's Expenditure Target by way of acknowledging that by rationalising the PA/Activity, an agency is actually making cost savings or using more efficient methods of operationalising the Activities.

In introducing this concept, many issues have to be settled such as who and what level of responsibility should undertake the evaluation; how is the program evaluation to be conducted; how will this evaluation be linked up to the budget process; and how will the outcome of the evaluation be reported.

Up till this point in time, there have not been any serious attempt to do any program evaluation. Further development from this stage is at best superficial. The Treasury has yet to come out with any pragmatic blueprint on how to conduct a program evaluation or how to operationalise one and has chosen to rely on the experiences of some implementing agencies to get feedback concerning possible program evaluation.

The rationale for this concept is that:

- it assist managers in improving program performance;
the program agreements are evaluated over an extended time period because such an exercise is time consuming and expensive to conduct on an annual basis and may disrupt normal work routines;

most program agreements need a certain number of years of implementation before any impact can be ascertained or measured

it represents a rational basis for long term decision making on resource allocation.

3. Benefits of MBS Reforms

The package of modifications as outlined above serves to benefit users of the system, be it at central level (Treasury), ministry or agency HQ level and line management level especially for responsibility centres at district and state levels.

3.1 The benefits at central level includes the following:

(i) Eliminate poker game syndrome by implementing agencies. By implementing the modifications it shifts the focus of budget examination to one of identifying priorities and best mix of resources with which to achieve certain targetted performance by the agencies.

(ii) Treasury officers need not have to be engaged in matters of expenditure details. The previous system was very much input oriented and discussion during budget examination tend to centre on expenditure requirements for a particular Activity rather than targetted performance for the new year. With the modifications,
outputs would be given greater emphasis and delegating inputs to a secondary role thereby giving more meaning to the concept of responsibility and accountability.

(iii) New Policies requirements are adequately reflected in the new year’s budget without compromising on the allocation for existing policies/services. Previously, agencies were merely asked to do with new policies by saving allocation from existing policies/services and thereby undermining the effectiveness of existing services. With the introduction of new policies and one-offs Treasury officials could monitor the effectiveness of new policies vis-a-vis the allocation provided.

3.2 The benefits that could accrue from this system for users at agency or ministry level include the following:

(i) Increased certainty of the actual quantum of allocation that Treasury would allocate to an agency for its existing policies. With this expenditure target, agency could plan their resources among its various programs and identify priority areas that may need more allocation. It would allow agency to have proper strategic planning at the beginning and thereby enable it to adopt a top-down approach to the budgeting process and eliminate many of the weaknesses inherent in the previous system such as too much preparatory paperwork; presentation of inflated budget; budget process becoming a “mechanical exercise”; no urgency among managers to “fight” for the allocation; no priority setting as the budget was merely incremental; and no incentive to venture and propose new areas of expansion.
(ii) By adopting a top-down approach, controlling officers could play a more active role in budgeting as he will have to sit together with the program heads at federal level to trash out the allocation "pie". In other words, he can use the budget as a management tool to make sure that top managers at federal level would do the necessary planning, organising and monitoring of the program under them. Previously, the controlling officer only came into the picture when the agency has finalised its annual budget to be submitted to Treasury and that too he is unsure of the quantum that will be finally approved to his agency. More often than not he would only be interested when the budget examination is over and the final amount approved for his agency as appearing in the budget estimate tabled in Parliament.

(iii) With this approach, it also allows better communication of top management's priorities to lower level managers at state and district levels thereby improving the quality of budget submission as it is in line with the top management’s intention.

3.3 The benefits that could be seen at line-management level include:

(i) Enable budget preparation at line-management level to take place simultaneously with the preparation of the work plans since these Responsibility Centre’s would have been given certain allocation by the agency HQ as well as certain targetted performance to be achieved during the new year. By so doing, it makes budget preparation at this level more meaningful and purposive as
managers are aware of top management’s priorities as they would be held accountable for the results.

(ii) There would be significant reduction of paperwork during the budget preparation stage since these line-management centres need not have to come out with inflated budget documents to be examined by their immediate organisational hierarchy superior and to redo the budget again once the examination at their level is over.