Prevention and Management of Government Expenditure Arrears

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Fiscal Affairs Department
I. Introduction

The accumulation of government expenditure arrears is one of the most common problems in public financial management (PFM). As shown in Figure 1, a survey of 121 Public Expenditure and Financial Accountability (PEFA) assessments revealed that in only 31 percent of countries the stock of central government arrears was less than 2 percent of total central government expenditure; in almost one-fifth of the countries it was more than 10 percent; in 22 percent it was between 2 and 10 percent; and in 28 percent the information was not available demonstrating lack of both adequate reporting and control.

Expenditure arrears have been an important issue in most IMF-supported programs. As shown in Figure 2, some IMF program countries accumulated expenditure arrears in excess of 20 percent of GDP. Arrears-related structural benchmarks or performance criteria were included in 95 percent of 140 IMF-supported programs between 1999 and 2012 and included reforms to strengthen the governments’ capacity to identify, verify, report, and clear existing arrears, and to enhance expenditure controls to avoid the accumulation of new arrears.

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Figure 1. Stock of Expenditure Arrears as a Percentage of Actual Total Expenditure PEFA Indicator 4 (i)
(In percentage)

Source: Scoring under PEFA assessments for 121 countries, during the period 2006-2012 See www.pefa.org.

Note: Indicator 4 (i) “Stock of expenditure payment arrears (as a percentage of actual total expenditure for the corresponding fiscal year) and any recent change in the stock” has the following scoring criteria: A=The stock of arrears is low (i.e. is below 2% of expenditure); B=The stock of arrears constitutes 2-10% of total expenditure; and there is evidence that it has been reduced significantly (i.e. more than 25% in the last two years); C=The stock of arrears constitutes 2-10% of total expenditure; there is no evidence that it has been reduced significantly in the last two years; D=The stock of arrears exceeds 10% of total expenditure.

Figure 2. Stocks of Arrears in Selected IMF-Supported Country Programs as Percentage of GDP, 1999–2012
(In percentage)

II. Definition and Typology of Expenditure Arrears

Government expenditure arrears are financial obligations that have been incurred by any level of the public sector for which payments have not been made by the due date. Payments may be overdue based on a particular legal obligation (such as payment of social security benefits, or salaries), a specific contractual commitment (such as payment for construction of a road), or a continuing service arrangement (such as payment for electricity supply). The value of expenditure arrears constitutes the amount of the original overdue payment, as well as any interest or financial penalties that the government might accrue (and not pay) as a result. Box 1 defines the key terms in the expenditure process.

The precise point at which a government liability falls into arrears typically varies according to the type of expenditure. In particular:

- **For compensation paid to individuals or transfers to households** in the form of wages, salaries, social benefits, and pensions, an arrear is created as soon as the legally or contractually defined date for payment of the obligation has passed.

- **For payment to commercial contractors** for provision of goods, services, or fixed assets, expenditure is considered to be in arrears when: (1) the goods have been delivered, service rendered, or asset created; (2) an invoice has been received; (3) the good, service, or asset has been verified as successfully delivered; and (4) the payment due date on the invoice or the number of days after which an invoice is to be paid in accordance with a law, regulation, payment policy, or local practice has passed.

- **For consumption of public utilities**, such as electricity, water, and telephone, for which there are general payment procedures applicable to all consumers, an expenditure is considered in arrears once the due date for regular payment has passed.

- **For mandatory transfers to statutory funds (such as social security funds) or subnational governments**, an expenditure falls into arrears once the due date for payment specified in the law, regulation, or calendar of transfers has passed.

- **For tax refunds owed to taxpayers**, such as value added tax (VAT) rebates or income tax refunds, the obligation becomes an arrear once the refund is due and the deadline for payment has passed.

- **For payment of interest or principal on government debt or other liabilities**, an expenditure falls into arrears as soon as the scheduled date for payment has passed. Arrears on amortization of debt are not defined as expenditure arrears for financial reporting purposes, as they constitute financing transactions under international accounting and statistical standards. However, they do represent an obligation to pay and should be disclosed and included in any arrears clearance strategy.

In practice, what constitutes a payment arrear may vary from country to country because there may be no clearly stated deadline for payment in laws, regulations, or policies. For example, in some countries, payment deadlines for the provision of goods and services are
Box 1. Definition of Key Terminology Related to Government Expenditures

Commitments are explicit or implicit agreements to make payments to another party in exchange for supplying goods and services or fulfilling other conditions. Commitments can be for specific goods and services and may arise when a formal action is taken by a government entity, for example, issuing a purchase order or signing a contract. Commitments can also be of a continuing nature that requires a series of payments. Commitments of this sort may or may not involve a contract, but they are often based on a legal obligation. This is the case, for example, for salaries, public utilities, and entitlement payments.

Liabilities are a subset of commitments and are established when one entity is obliged under specific circumstances to provide funds or resources to another party. Liabilities include outstanding debt, leases, and provisions, as well as payables for provision of goods delivered or services rendered. The liability arises when a third party satisfies the terms of the contract or similar arrangement. Not all commitments become liabilities, for example, when the obligation to deliver goods or services is not satisfied by the supplier as specified in the agreement.

Payables (or creditors) are a subset of liabilities for which the related goods or services have been provided by a third party but not yet paid for by the recipient. A payable is created when an invoice is approved for payment and has been recorded in the general ledger or accounts payable subledger as an outstanding liability awaiting payment.

Expenditure arrears are a subset of payables that have remained unpaid beyond a specified due date for payment. In cases where no due date is specified, arrears are defined as payables that have remained unpaid after a specified number of days after the date on the invoice or contract, in accordance with a law, regulation, government payment policy, or local practice.

Government Expenditure Chain

| Order for goods/services placed. | Goods and services delivered, invoice received. | Invoice approved for payment. |
| Commitment created, amount reserved against budget. | | Expense and Payables created. Commitment is replaced by an actual expense. |
| Payment made by due date. | | Payable is reversed, and cash is reduced by the corresponding amount. |
| Payment not made by due date. | | Payable remains as a Liability in the books. Payment is in Arrears. |

defined only in individual contracts. In others, the deadline for payment is set out in a law or regulation. International practice on what is an acceptable delay between receipt and payment of the invoices varies from anywhere between 30 to 120 days (Box 2). In low-income countries, the period defined may depend on the efficiency and maturity of the payment system. Where there is a defined policy on timely payment of invoice, once the
III. Economic Impact of Chronic Arrears Accumulation

The accumulation of expenditure arrears by governments can have a serious negative effect on the domestic economy. Control and clearance of arrears have been priority in almost all IMF-supported programs over the past decade. The 2008 financial crisis in Europe demonstrated that the accumulation of arrears can be a problem in advanced economies, such as Portugal, Brazil, the United Kingdom, and the United States, make it a policy to pay small and medium enterprise suppliers within fewer days than the 30 days from receipt of invoice to enable firms, often financially constrained, to build up working capital. Some countries provide for a longer period for capital contracts to allow for an evaluation of the services provided. Examples of statutory payment deadlines in different countries are as follows:

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Source: PEFA assessments 2006–2012 (see www.pefa.org) and country websites.

For a longer period for capital contracts to allow for an evaluation of the services provided. Examples of statutory payment deadlines in different countries are as follows:

### Box 2. Payment Terms for Commercial Contracts in Various Countries

The typical due date for payment of government suppliers varies across countries, transactions, and sometimes type of supplier. The European Union’s (EU) Late Payments Directive (EU, 2011) requires all public entities in EU member countries to pay their suppliers within 30 days of delivery of goods or rendering of services, or pay a flat-rate compensation plus interest on a daily basis at 8 points above the central bank’s rate on the amount overdue. In low-income countries, the payment period is often longer and may depend upon the efficiency and development of the payment system. Some countries, such as Australia, Brazil, the United Kingdom, and the United States, make it a policy to pay small and medium enterprise suppliers within fewer days than the 30 days from receipt of invoice to enable firms, often financially constrained, to build up working capital. Some countries provide for a longer period for capital contracts to allow for an evaluation of the services provided.

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Not defined countries include:
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Source: PEFA assessments 2006–2012 (see www.pefa.org) and country websites.
Greece, Spain, and Italy. As pointed out by Diamond and Schiller (1993), a large flow of arrears may disguise the true size of the government deficit, significantly reduce the impact of fiscal policy on aggregate demand, and potentially undermine macroeconomic stability. The economic consequences of persistent arrears accumulation by governments can include the following:

- **Reduced economic growth.** Arrears imply a liquidity problem in the economy which can have a detrimental impact on aggregate demand. If businesses are dependent on government contracts, payment arrears can cease or delay activity as a result of payment delays or impose difficulties in accessing credit from commercial banks, resulting in a reduced pace of economic activity and increased unemployment.

- **Increased cost of service provision.** Government suppliers try to mitigate the risks and opportunity cost of delayed payments by adjusting their initial prices upward. This reduces the efficiency of government expenditure and contributes to economy-wide inflation.

- **Reduced or interrupted public service delivery.** As the cost of supplies rise, governments with limited resources may be forced to reduce the amount of supplies purchased and/or the volume of service provided. Suppliers themselves may require that government pay for goods and services in advance, that quantities supplied be limited, or that delivery of further supplies or services be made dependent on the payment of outstanding amounts. The delivery of public services may be halted entirely if suppliers cease supplying essential services (such as electricity, water, medicine, or fuel) or stop or delay the construction of investment projects.

- **Increased rent-seeking.** Chronic payment delays also increase the incentives for rent-seeking and collusion between government and suppliers, as the latter seek to accelerate payment or circumvent expenditure control procedures.³

- **Increased interest rates.** Illiquid suppliers may try to bridge the delay in payments by borrowing from banks, adding pressure to credit markets, and driving up interest rates. These pressures, in turn, may induce the central bank to relax monetary policy, further driving up the domestic price level.

- **Reduced confidence in fiscal policy.** Significant expenditure arrears can disguise the true size of the government’s liabilities by as much as 20 percent of GDP.

- **Second-round fiscal costs.** As government suppliers suffer from liquidity shortages, lower profits, reduced employment, and falling confidence in government, they may be inclined to reduce or withhold payment of taxes and social security contributions until, in turn, they receive payments due to them from government.⁴

³ For a detailed discussion of rent-seeking in the entire expenditure management system, see Garamfalvi (1997).

⁴ Although the accumulation of tax arrears in also a serious fiscal management issue for many countries, it is not addressed in this TNM. For a discussion of the causes, prevention, and clearance of tax arrears, see Brondolo (2009).
IV. Causes of Expenditure Arrears

Expenditure arrears arise when governments are unable to discharge their payment obligations in a timely manner. The temporary accumulation of government expenditure arrears is sometimes the result of acute government liquidity shortages that accompany serious economic or financial crises. Once the immediate shock of the crisis has passed, revenues recover, and the government is able to access financial markets, arrears tend to be paid down quickly and often do not re-emerge.

Persistent expenditure arrears are typically a symptom of underlying weaknesses in a country’s PFM system. Expenditure arrears can be the result of failures at any or all stages of the PFM cycle, including inadequate legal frameworks, unrealistic budgeting, weak or cumbersome expenditure controls, inefficient cash management, lack of or problems with a financial management information system (FMIS), or gaps in fiscal reporting. The most effective approach to dealing with expenditure arrears, therefore, depends on their underlying causes and usually requires concerted action in a number of PFM areas. As described in Table 1, the expenditure process can be thought of as comprising four stylized stages: budget formulation, expenditure commitment, expenditure liquidation or verification, and payment. Weaknesses, errors, or delays at any stage can result in the accumulation of expenditure arrears.

Another reason that expenditure arrears can accumulate is that governments are not aware of them. As shown in Figure 3, a survey of 121 low- and middle-income countries found that 38 percent were unable to generate reliable data on the stock of unpaid bills from the past two years. Only 12 percent of countries regularly generate reliable data on the stock and vintage of arrears. The reason for the lack of awareness of arrears can be due to weaknesses in the fiscal reporting system. First, some accounting systems are unable to determine liabilities or the sub-set of liabilities that are beyond the due date: for example, the date of the invoice or the date the invoice is payable is not registered systematically in the FMIS or general ledger. Second, in many countries, particularly those operating cash-based budgeting and accounting systems, there is no requirement to report arrears, or if a requirement exists, reporting is at the year-end only. Finally, the government reporting entity is often restricted to the central government budget, while arrears may be building up in extra-budgetary funds, autonomous agencies, subnational governments, and state-owned enterprises.

While inadequate monitoring and reporting of arrears can complicate prevention and management, their underlying cause is usually one or more weaknesses in the PFM process. The most common causes include:

- **Formulation of unrealistic budgets.** Unrealistic budgets can be the result of overly optimistic macroeconomic or revenue projections and/or under-provisioning for compulsory expenditure items. On the revenue side, uncertainty regarding the scale and timing of...
### TABLE 1. STAGES OF EXPENDITURE PROCESS AND CAUSES OF ARREARS

<table>
<thead>
<tr>
<th>Stage</th>
<th>Good Practices</th>
<th>Causes of Arrears</th>
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</table>
| **1. Budget Formulation** | • Government prepares and submits the budget for legislative approval based on a realistic medium-term fiscal framework or annual budget projections.  
• Government has comprehensive assessment of fiscal risks.  
• Contingency provisions are used to accommodate unplanned, unavoidable, and unforeseen expenditures.  
• Budget reflects expenditure commitments carried forward from prior years. | • Budget is not realistic; prior year commitments are not fully reflected in the budget; revenues are over-estimated, and expenditure is under-estimated. Weak medium-term projections are unable to ensure proper financing and assess future years’ financial consequences of costs of new entitlements, increases in salaries, and new investment projects.  
• Inadequate assessment of fiscal risks and measures to mitigate them.  
• Unplanned expenditures; change in macro-economic indicators; significant variation in prices; unexpected called guarantees; and court decisions without mechanisms to accommodate them, such as contingency reserves.  
• Capacity to finance the deficit is overly optimistic, particularly in countries heavily dependent on external financing and with a small financial market. |
| **2. Expenditure Commitment**<sup>1</sup> (Encumbrance or Engagement) | • Legal right to acquire goods or services is made with the issuance of a purchase order or contract, and commitments are recorded at this stage for all types of expenditures.  
• Cash planning reflects commitment profiles.  
• Monitoring and control mechanisms cover all budgetary and extra-budgetary funds for the public sector. | • Some expenditures are not included in the commitment control system; for example rents, public utility bills, salaries, and transfers.  
• Forecasted cash availability is unreliable and does not guide commitment ceilings.  
• Commitment monitoring and control mechanisms for extra-budgetary funds and entities operating outside of the budget are inadequate. |
| **3. Expenditure Verification**<sup>2</sup> (or liquidation) | • Work is completed, goods and services are delivered, and the invoice is received.  
• Liability is registered in an accrual accounting environment. The liability arises when the third party satisfies contractual obligations. The invoice becomes an obligation, and the payment due date is registered in the accounting system.  
• In cash accounting systems, controls are in place to track commitments and liabilities. | • The supplier may agree informally with the spending unit not to submit the bill or invoice until an appropriation is available.  
• The spending unit may not register an invoice. The date of the invoice is not captured in the accounting system.  
• In a pure cash accounting environment, there is no tracking system to capture commitments and liabilities. |
| **4. Payment** | • Request for payment is made by the accounting or financial officer, and a payment is recorded in the accounting system, removing the liability.  
• Finance department/treasury processes orders and issues checks or electronic transfers.  
• Payment due date is known, and available funds are in government bank accounts on the due date.  
• There is a chronological sequence for payment.  
• Checks are cashed/electronic transfers made expeditiously in favor of the creditor. | • Payment orders are not processed in a timely manner.  
• Cash is rationed because cash flow forecasting is poor and available cash is insufficient to meet the payment obligations.  
• Bank reconciliation is infrequent, and available bank balances are unknown.  
• Officials do not respect a chronologic sequence of payment and selectively retain payment orders.  
• Central bank or commercial banks may hold on to checks or transfers due to lack of cash available in bank accounts, resulting in a float of unpaid checks. |

<sup>1</sup>Some countries also have a reservation (or pre-commitment) stage, in which the budget is reserved while information is gathered (for example, during the tendering process or preparation of the payroll). This may be incorrectly treated as a commitment (as occurred in, for example, in Italy or Portugal) but no contractual obligation to pay has arisen.

<sup>2</sup>In most francophone countries, the period for officially recognized arrears runs from the acceptance by the treasury (prise en charge) of the payment order (mandat) and not from when the good or service is delivered and the invoice received. The period between the acceptance of goods and services (liquidation) and their payment may be prolonged and is not accounted for when officially measuring the flow of arrears.
external budget support can pose a particular problem for developing countries. This uncertainty can be also an issue in resource-rich countries significantly dependent on revenues from natural resources (for example, oil and minerals), where volatility of international prices of the commodities can complicate budgetary projections. On the expenditure side, deliberate under-budgeting for infrastructure, entitlements, subsidies to state-owned enterprises or essential items (for example, utilities, pharmaceuticals, maintenance, or food for hospitals, prisons, and schools) is sometimes used as a tactic by ministries and agencies to get initial authorization for a broader range of expenditure than the ones that can ultimately be afforded.

- **Lack of commitment controls.** Controlling commitments is essential for controlling expenditure and preventing arrears (Radev and Khemani, 2009). Commitment controls manage the initial incurrence of obligations, rather than the subsequent cash payments, to avoid the accumulation of unaffordable liabilities and unpaid bills. Commitment controls based on expenditure ceilings or cash limits reconcile the availability of cash resources with commitments, thereby ensuring that spending units are able to enter into contracts or other obligations only if sufficient unencumbered balances are available, or are likely to be available, at the time of payment. Empirical evidence shows a strong relationship between the accumulation of arrears and the lack of proper commitment

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**Figure 3. Availability of Data on Expenditure Arrears in 121 countries, Indicator 4(ii) (2006-12, PEFA scores)**

(In percentage)

- A- Reliable and complete data: 12%
- B- Data generated annually, but incomplete: 26%
- C- Data based on ad hoc exercise: 17%
- D- No reliable data: 38%
- Not scored: 7%

Source: www.pefa.org.

Note: Indicator 4 (ii) “Availability of Data for Monitoring the Stock of Expenditure Payment Arrears” has the following scoring criteria: A= Reliable and complete data on the stock of arrears are generated through routine procedures at least at the end of each fiscal year (and includes an age profile); B= Data on the stock of arrears are generated annually, but may not be complete for a few identified expenditure categories or specified budget institutions; C= Data on the stock of arrears have been generated by at least one comprehensive ad hoc exercise within the last two years; D= There are no reliable data on the stock of arrears from the past two years.
controls. Table 2 shows the relationship between PEFA indicators related to arrears and commitment controls. Countries with strong commitment controls tend to have lower stocks of arrears and countries with poor commitment control have a higher tendency to accumulate significant expenditure arrears.

- **Poor cash management.** Even where expenditure commitments are registered and controlled within available expenditure ceilings or cash limits, arrears can accumulate if sufficient liquidity is not available to pay invoices when they fall due. Commitment limits therefore need to be linked to projected cash inflows and appropriate mechanisms set up.

### Table 2. Relationship between PEFA indicators PI-4 (i) Stock of arrears and PI-20 (i) Commitment controls

<table>
<thead>
<tr>
<th>Indicators</th>
<th>PI 20 – (i) Effectiveness of expenditure commitment controls.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>C</strong></td>
<td>Afghanistan (2008), Colombia (2009), St. Lucia (2010), Tanzania (2010)</td>
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Source: PEFA assessments of 85 countries from 2006-2012 (see www.pefa.org).

Note: PEFA Indicator PI-20 (i) “Effectiveness of expenditure commitment controls” has the following scoring criteria: A= Comprehensive expenditure commitment controls are in place and effectively limit commitments to actual cash availability and approved budget allocations (as revised); B= Expenditure commitment controls are in place and effectively limit commitments to actual cash availability and approved budget allocations for most types of expenditure, with minor areas of exception; C= Expenditure commitment control procedures exist and are partially effective, but they may not comprehensively cover all expenditures or they may occasionally be violated; D= Commitment control systems are generally lacking OR they are routinely violated. PEFA Indicator PI-4(i) See note to Figure 1.
within the ministry of finance to collect forecast data from budget agencies, aggregate the data, and produce rolling forecasts to guide expenditure commitment ceilings (Lienert, 2009). The government banking arrangement should be unified in a treasury single account (Pattanayak and Fainboim, 2011) to enable the ministry of finance or treasury to track government cash flows in and out of these bank accounts and pool liquidity. The treasury, as the chief financial agent of the government, should manage the government’s cash and debt positions to ensure that sufficient funds are available to meet payment obligations, idle cash is efficiently invested, and debt is optimally issued.

- **Delays in processing of payments.** Even where commitments are controlled and liquidity is available to make payments, arrears can arise due to administrative delays in the processing of expenditure transactions. Excessive documentation requirements, cumbersome ex ante audits, or lack of manpower or automation can slow the processing of invoices and making of payments. Delays occur at various stages and are sometimes associated with rent-seeking, lack of resources, weak capacity, and inefficient procedures.

- **Deliberate deferral of payments.** In countries that account and report fiscal data on a cash basis, governments may be tempted to deliberately delay payments as a means of reporting a higher cash balance in the short term, notably at the end of the fiscal year (Irwin 2012). This is a particular risk in election years, when the incumbent government may pass on to the next administration a large balance of outstanding payments without correspondent resources to finance them.

- **Inadequate sanctions.** Expenditure controls can be undermined by ineffective sanctions, or an unwillingness to enforce them, against officials or institutions who fail to comply with the law. This noncompliance may include the following: entering into commitments above expenditure ceilings or budget limits; failure to register commitments; fraud or collusion with suppliers; or failure to prepare and publish budget execution reports and financial reports. The legal framework should clearly specify financial management responsibilities and sanctions for noncompliance both at personal and institutional levels. Sanctions can be administrative (dismissal or suspension), criminal (imprisonment or prohibition from running in elections), financial (fines), or organizational (reduce the financial flexibility of the entity or suspend or reduce appropriations).

**V. Prevention and control of expenditure arrears**

The most effective way to control the accumulation of arrears is to prevent arrears from being incurred. Therefore, the first step in preventing arrears is to understand the underlying causes. Once the causes have been identified, the range of potential remedies includes the following:

- **Strengthening the legal and regulatory framework.** The legal framework or related regulations should define payment terms (and when a payment is in arrears); reporting
requirements; controls at the budget authorization, commitment, and payment stages; and the sanctions associated with any breach of those provisions.

- **Enhancing the credibility and realism of the budget.** One of the first steps in addressing a persistent arrears problem is to strengthen the realism of the annual budget. This will depend on robust assumptions and forecasts in the fiscal framework on which the budget is based. Other basic steps can help to ensure that annual budgets reflect spending requirements. Among the actions that the ministry of finance should perform are the following:
  - Check that costs are estimated adequately through analysis of the historic behavior of each category of expenditure, with a particular focus on those items prone to arrears—typically non-discretionary items, such as utilities, maintenance costs, supplies for schools and prisons, and discretionary items, such as infrastructure projects;
  - Ensure that risks to the budget are adequately estimated and provided for, using contingency reserves;
  - Ensure that outstanding commitments of multi-year investment projects are included in the budget and outer-year forecasts; and
  - Provide ministries and agencies with greater medium-term certainty about their resources. This is especially critical in the area of complex, multi-year investment projects. In more sophisticated PFM systems, a credible medium-term budget framework (MTBF) sets expenditure ceilings for each budget entity with a horizon of three to five years. This increases the predictability of resources in the medium term and prevents the introduction of new, or the scaling up of, projects and programs without consideration of the medium-term fiscal capacity to finance them.

- **Improving accounting and reporting.** The prevention, management, and clearance of arrears require comprehensive, timely, and reliable information about their size, composition, and vintage. Government accounting systems should recognize expenditure commitments, liabilities, and payments. In the near term, cash accounting systems that recognize transactions only when cash movements occur need to be supplemented with separate reporting mechanisms for monitoring expenditure commitments, invoices received and verified, accounts payable, invoices paid, and arrears. These arrears monitoring systems should capture the size, maturity, and composition of the stock of arrears; this information can be used as the basis for identifying their causes and prioritizing their clearance. In the longer term, accrual accounting systems, which recognize a liability when a service is delivered or goods are received, would enable the systematic monitoring of liabilities. Whether accounting is on a cash or accrual basis, reporting of accounts payable and identifying those in arrears should be an integral part of the regular monthly fiscal report and be disclosed in the annual financial statements, as was the case in Greece and Portugal.\(^7\)

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• **Strengthening commitment controls.** Commitment controls are part of the internal control system, which should prevent public entities from initiating expenditure without available budget and cash. In countries with integrated FMIS, it may be possible to enforce commitment control through the centralized generation of a commitment authorization number, which is provided to suppliers when the contract is signed. In some countries, such as Brazil (Box 3), the commitment number is generated earlier in the bidding process, providing assurance to potential suppliers that they are participating in a bidding process for which budgetary funds have already been secured.\(^8\) In countries where there is no functioning FMIS, manual ledgers should be designed and maintained to capture approved budget, commitments, and expenditure, and a regular reporting framework instituted.

• **Improving cash and debt management.** Reliable cash forecasting should ensure that liquidity is available to meet payment obligations as they arise. For effective cash management, the treasury needs to develop accurate and timely short-term estimates of cash inflows and outflows. Spending agencies should be required to prepare financial plans—both a schedule of commitments and likely cash outflows. In turn, the ministry of finance needs to be responsive to the cash needs of spending agencies by operating a treasury single account with an adequate cash buffer to make payments as they arise. In countries where spending agencies are not equipped to prepare cash plans, the treasury may need to centralize payments and prepare a cash plan based on the liquidation information and payment due date. In countries with liquid domestic money markets, governments can issue short-term treasury bills to address temporary liquidity shortages created by mismatches in the timing of receipts and payments.\(^9\)

• **Enhancing oversight of subnational governments and state-owned enterprises.** In addition to central government arrears, significant problems have been identified at the subnational level and in state-owned enterprises in many crisis countries. Central governments often carry an implicit contingent liability for subnational government and state-owned enterprise debt. Accordingly, the legal frameworks for subnational governments and governance frameworks for public corporations should require timely payment of bills and regular monitoring and reporting of these liabilities. Governments with more developed reporting capacity should aim at consolidated fiscal reporting for the entire general government or public sector.\(^10\)

• **Implementing other technological solutions.** Many countries, particularly in sub-Saharan Africa, have used advancements in information, communications, and technology to control expenditures that have historically contributed to the accumulation of arrears.\(^11\)

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\(^8\) Commitment controls are discussed more fully in Radev and Khemani (2009).

\(^9\) For additional details on cash management, see Lienert (2009); also see Gardner and Olden (2013).

Box 3. Brazil: Comprehensive Strategy to Prevent the Accumulation of Expenditure Arrears

Brazil implemented a set of measures to prevent arrears accumulated as a result of the fiscal crisis of the 1990s. These include legal, institutional, and operational reforms:

**Fiscal Responsibility Law (FRL):** The FRL provides that budget carry over (restos a pagar) is authorized only if there is the equivalent available cash in the Treasure Single Account (TSA) at the end of the fiscal year. In election years, it is forbidden to commit expenditure that will not be paid in the current mandate; no new commitment is allowed six months before the election or when no financial resources are available in the TSA at the end of the mandate.

**Fiscal rules:** Any expense not paid is considered a liability and part of the general government gross debt. The FRL specifies that net recurrent revenues related to the gross debt cannot exceed 200 percent for states and 120 percent for municipalities.

**Integrated financial management information system (IFMIS):** These systems were implemented in the central and state governments to control all stages of expenditure (budget appropriation, commitment, liquidation, and payment).

**TSA:** The TSA was created at the same time as the IFMIS. All tax and non-tax revenues are electronically collected through the banking system, and receipts are deposited in the central bank.

**Commitment control:** To pay any bill, it is obligatory to register the commitment, liquidation, and payment stages in the IFMIS; otherwise, payment cannot be processed.

**Procurement:** Procurement entails the implementation of a transparent bidding process during which the commitment number generated by the IFMIS has to be identified. This process is to provide a guarantee to suppliers that budget is available and reserved to finance the specific expenditure.

**Payment of interest:** Each contract to supply goods and services requires that the government pays a penalty if expenses are paid more than 30 days after the due date.

**Control:** The Supreme Audit Institution (Tribunal de Contas da União) has the power to stop any contract or payment that is considered potentially harmful and can fine officials that incurred irregularities.

**Arrears reporting:** Comprehensive fiscal reports published monthly provide information on commitment, liquidation, and payments by each budget entity and by budget line item. The overall liabilities are published separately, but the value of payments in arrears is not.


Such measures include prepaid mobile phones or telephone cards, meters for utilities, and prepaid cards to purchase fuel and certain supplies. Other measures may include centralizing the acquisition of common goods and services to increase the bargaining
power of the government to negotiate better prices, and authorizing public utilities (such as electricity, telephone, and gas) to suspend the service to public entities that do not pay their bills.

- **Upgrading the government financial management information systems.** A modern FMIS must be capable of controlling the main stages of budget execution. It should include information on the original budget, supplementary budget, commitments (including multi-year commitments), liquidations, payments, payment due dates, and payments in arrears (see Box 4).

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**Box 4. The Senegal Approach to Clear and Prevent Expenditure Arrears**

Unpaid bills had been a problem for the Senegalese government for a number of years, reaching a crisis point in October 2008, when they rose to 7 percent of GDP. The arrears were partly as a result of cash flow difficulties stemming from increases in food and energy subsidies, poor budget management, and reduced liquidity in the West African Monetary Union (WAEMU). The government recognized the need to implement measures to address the problem.

At the outset, the government appointed external auditors to verify the outstanding payments. Valid claims were then scheduled for repayment through the budget process, and invalid claims were rejected. In addition, the government initiated the following measures:

**Fiscal Reporting.** Reforms were implemented to improve the format and transparency of budget reports, including presentation of past year and current year actual expenditure data, and inclusion in the annual budget law of an annex with budget execution and forecast data of all agencies receiving funds from the budget in excess of CFAF 5 million.

**Financial Management Systems.** The budget execution monitoring system (SIGFIP) was reconfigured to improve its efficiency, enhance the reliability of real-time data, and expand its coverage to enable monitoring at each stage of budget execution. Interfaces were developed with accounting software, which was rolled out to all accounting units.

**Sanctions.** Administrators who illegally created a liability for the government by knowingly committing expenditure in excess of authorized appropriations were brought before the financial disciplinary chamber of the court of audit and subject to penalties.

**Clearance Strategy.** The stock of arrears was reduced by end-March 2009 to 1 percent of GDP through reprioritization of investment spending, mobilization of resources from WAEMU financial markets, and support from donors, coupled with prudent and rigorous public financial management systems.

Strategies to deal with arrears should be tailored to the specific circumstances of the country.\textsuperscript{11} Appendix 1 presents possible priority reforms that countries may implement, and Appendix 2 provides a sample of the main causes of arrears in a variety of IMF-supported program countries and measures adopted to resolve the problem.

VI. Clearance of Expenditure Arrears
Once a country has identified the causes and designed the measures to address the accumulation of arrears, it needs to develop a strategy to eliminate the outstanding stock. This strategy should communicate to stakeholders the government’s plan, timetable, and criteria for the liquidation of arrears, thereby minimizing any possibility for any perception of favoritism and corruption in the selection of creditors to be paid. The following key factors should guide the arrears clearance strategy:

- **Comprehensiveness.** The arrears clearance strategy should apply to all outstanding payments incurred by all parts of the public sector, whether in the central government, subnational governments, or state-owned enterprises.
- **Transparency.** The clearance of arrears should proceed according to a public timetable, and criteria for prioritizing clearance should be transparently stated and adhered to.
- **Credibility.** To demonstrate commitment to addressing the root causes of the problem, the strategy should include measures to avoid the accumulation of new arrears, and ministries or agencies that fail to implement these measures should be penalized appropriately.
- **Realism.** The government’s annual budget and medium-term fiscal projections should make adequate provision for the cash cost of arrears clearance.
- **Verification.** Arrears should be verified to ensure that only valid claims are cleared.

A comprehensive, transparent, and credible arrears clearance strategy should typically follow five steps: stocktaking, verification, classification, prioritization, and liquidation. This Section discusses the specific actions that need to be taken at each step. Boxes 3 – 7 provide illustrations of how different countries developed and implemented such strategies.

A. Stocktaking of Arrears
A thorough stocktaking of arrears should enable the government to understand the extent, composition, and vintage of the government’s unpaid bills and prioritize their clearance. A timetable should be communicated for the stocktaking exercise, and a clear definition of the information requirements should be provided to all relevant institutions. A cut-off date for inclusion of new arrears should be established to encourage timely reporting and avoid the

generation of fraudulent claims.\textsuperscript{12} Even fully functioning FMISs typically do not cover the whole of general government or public sector, so the stocktaking of the arrears will require supplementary data collection.

A database of all apparent claims should be prepared, and a regular reporting framework should be instituted. The database should have enough information to allow the define and

\textsuperscript{12} In many countries, the government may lack the authority to impose penalties for failure to report in a timely manner – the central government may only have the legal mandate and the political power to collect data in relation to the budget, and possibly some extra-budgetary funds. Such limitation of powers should be considered in the review of the PFM legal framework.
classify arrears into the categories set out in Section VI.C. This framework should include all entities that have generated arrears, whether central government, subnational governments, or state-owned enterprises. If the central government is not directly responsible for clearing arrears at the subnational government level, the central government should be able to define the standards to be observed and ensure that the rules are been followed. Sanctions for non-reporting, fraudulent, and incomplete reporting of arrears should be announced and enforced.

Using the information produced from the database, a review of the types of arrears, their vintage, and the spending agencies generating arrears should be undertaken. This will help to identify the underlying causes and the specific corrective actions required to address them. For example, if utilities payments are in arrears, actions such as pre-payment of utility bills could be considered or a stricter control over virements on budget lines for utilities introduced. The review will also help to assess whether the problem is restricted to past events, or whether the problem persists.

B. Verification of Arrears

Once data on the outstanding stock of arrears has been collected, the data should be verified to ensure that they are genuine claims to avoid payment of fraudulent claims. This activity can be undertaken by the supreme audit institution, an inspectorate or internal audit function in the ministry of finance, or private audit firms, depending on the legal and institutional arrangements and capacity available. All reports and relevant information should be provided to the external auditor. This process should include the following steps:

**Step 1. Collection of unpaid invoices:** The initial responsibility for producing the necessary documentation should rest with the chief financial officer of the entity. The responsibility for the proof of validity of claims without proper documentation should rest with the claimant. Only original documentation should be accepted, not photocopies, to avoid fraudulent claims.

**Step 2. Verification of claims:** Arrears should be subject to tests to verify their existence, value, and vintage. Arrears should be verified using the following guidelines:

- The legal validity of the payable should be verified by checking that the transaction was duly authorized by a responsible officer in accordance with authorized public finance and procurement laws, rules, and regulations and consistent with budgetary authorizations. Where this is not the case, appropriate sanctions should be applied to officials, and a legal assessment should be made as to whether the claim is valid.
- Evidence that the goods were delivered and services were duly received and accepted by a responsible officer should be verified. In case of doubt or for material transactions, delivery should be reconfirmed by requesting information from the supplier. For goods and services, the financial records of the supplier can be asked to show that amount was registered as a receivable in their accounts. In cases of salary arrears, payroll records...
should be checked to ensure beneficiaries were employed at the time. In more complex transactions, particularly those related to major construction or other investment projects, evidence of progress or a completion certificate produced by relevant experts should be required.

- Invoices and supporting documentation should be checked to verify the value of the amount payable. Invoices should contain the following information at a minimum: the amount, the supplier, the reference to the contract or purchase order signed by the responsible officials, and the documents confirming receipt of goods or services, such as the inventory records of the purchasing entity. In case of doubt, cross-checks with suppliers’ financial statements should be made.
- The age of the payable should be checked by reference to the invoice and other supporting documentation. A confirmation from the supplier should be obtained in contentious cases.
- The ministry of finance, taking full account of the legal framework with respect to disclosure of taxpayer records, should undertake checks with the revenue authority to ensure that suppliers are registered taxpayers and determine whether they are delinquent in tax payments.

Box 6. Liberia: Strategy to Clear and Prevent Fresh Expenditure Arrears

Liberia emerged from the civil war with domestic arrears to civil servants, suppliers, and domestic financial institutions that were estimated in 2006 at US$914 million (150 percent of GDP). Responsibility for the arrears clearance process was vested in a deputy minister of finance, who created mechanisms for liaison between the debt management unit responsible for maintaining records of verified claims, the legal counsel of the ministry of finance, and the ministry of justice (to provide legal advice on validity of claims). Appropriations were made in subsequent budgets to cover the claims.

Verification. Following an extensive verification exercise with the assistance of the auditor general, claims were placed into three categories: valid, contestable, and rejected. Holders of contestable claims were invited to provide further documentation. US$304 million (50 percent of GDP) in claims were found to be valid.

Commitment controls. Stringent centralized manual commitment controls were introduced to prevent the accumulation of new arrears.

Clearance strategy. The government developed a comprehensive domestic arrears resolution strategy. Valid claims were discounted at an agreed rate; agreements were made with financial institutions to repay the claims over a 30-year period, beginning in 2007/08, with debt service charges increasing in the outer years, following a four-year grace period on principal repayments.

A 2012 PEFA study indicates that arrears balance had fallen to US$49 million (4.2 percent of GDP) by the end of 2011.

**Step 3. Categorization of claims:** Based on this review of validity, each claim should be categorized as valid, contestable, or rejected. Valid claims are those for which adequate documentation exists to recognize a government liability. Contestable claims are those for which incomplete documentation has been provided. Rejected claims are those for which legitimate documentation has not been presented.

**Step 4. Appeals from claimants:** Holders of contestable claims may be invited to provide further documentation to support their claims or have their claims referred for adjudication. Such claims may arise through collusion with government officials or poor record keeping. The burden of proof on the validity of such claims should rest with the claimants, and the government may decide to settle them in the future on a case-by-case basis, based on the recommendations of the external auditor or independent adjudicator. Claim holders should have the right to appeal the external auditor or independent adjudicator’s decisions through the judicial system.

**Step 5. Rejection of invalid claims:** The government should formally notify rejected claimants and state the basis of the rejection. It is essential that government retain full records of decisions made to defend future legal actions by claimants. Box 6 outlines the approach that Liberia took to verification and arrears clearance.

**C. Classification of Arrears**

Once collected and verified, arrears data should be analyzed and classified for the purposes of arrears clearance. A database of valid outstanding payments should be established and maintained centrally by the ministry of finance. This can be a resource-intensive and time-consuming exercise, requiring dedicated staff resources. A practical approach would be to focus in the first instance on large claims, gradually expanding the coverage of the database. Entitlement arrears should be calculated by the social security ministry or agency and provided to the ministry of finance. The local government ministry should be responsible for the collection of arrears data for subnational governments. To allow for appropriate categorization, the following data should be captured for each outstanding claim:

- **Vintage:** The database should capture the original due date on each invoice, and arrears should be classified according to how long they have been overdue: one to three months, three to six months, six to 12 months, and more than 12 months. Older arrears should be classified by the financial year in which they were incurred. If the due date is not recorded in the invoice, the invoice date can be used as a proxy for the due date.
- **Debtor:** The database should capture the government entity incurring the liability, classified by institutional group (central government, subnational government, agency, extra-budgery fund, or state-owned enterprise).
- **Creditor:** The database should capture the creditor name classified by type: employees, private individuals, private businesses, financial institutions, central government,
subnational government, extra-budgetary funds, or state-owned enterprise. Clearly distinguishing extra-government and intra-government obligations will facilitate rapid administrative clearance of the latter.

- **Economic category:** The database should classify arrears by GFSM 2001 economic category, such as compensation of employees, acquisition of goods and services, transfers, acquisition of nonfinancial assets, and acquisition of financial assets.

- **Currency:** The database should capture the currency in which the obligation was originally denominated so that cash managers can ensure that sufficient foreign exchange is available to meet external arrears.

- **Contractual terms:** The database should capture any relevant contractual information including, for example, whether the outstanding balance results in interest and/or penalties for non-payment.

- **Payment status:** The database should capture the total amount due on the invoice, amounts already paid, amount outstanding, and any rescheduling, discounting, or factoring of the unpaid obligation.

- **Risk of non-payment:** The database should include a risk assessment of further payment delays. For example, if civil servants are not paid, there could be potential for industrial action; if a contractor for a major infrastructure project is not paid, the project may not be completed, or completion may be delayed for many years. Other risk factors would include litigation and potential socioeconomic impacts.

When the database has been established, the ministry of finance should keep it up-to-date showing the discharge of arrears and any subsequent additions to the stock. All stocks of accounts payable (see definitions in Box 1) should be classified as liabilities, further classified as either domestic or foreign, and included in the government’s measurement of gross debt.\(^\text{13}\) Payments in arrears should be included as a memorandum item to the government’s balance sheet.

**D. Prioritization of Arrears for Clearance**

Once a database of valid claims on government has been established, a set of criteria for prioritizing their liquidation should be determined. The prioritization of arrears clearance should be based on transparent criteria; depending on the nature of the arrears, these might include the following:

- **Socioeconomic impact:** Arrears to economically sensitive or vulnerable sectors, such as salaries of low-income workers, pensions, and social benefits, should be prioritized.

- **Vintage:** Older obligations should have priority over newer obligations.

- **Cost:** Arrears that accrue interest and penalty charges should have priority.

- **Risk:** Arrears that may result in legal action, disruption of essential services, or cost escalation of future supplies to government should be prioritized.

\(^{13}\) In accordance with *GFSM 2001* and other macroeconomic statistical systems. For European countries arrears are not included in the measure of Maastricht debt (while they are included in expenditures and deficit).
• **Currency:** Payment of foreign currency denominated debt should be prioritized if domestic currency devaluation is outpacing domestic inflation.

• **Creditor:** The government should prioritize the clearance of intra-government debts, as this can be done administratively though the annual budget at minimal net cost.

**E. Liquidation of Arrears**

Once the criteria for prioritizing arrears for clearance have been established and published, the payment or liquidation of obligations can begin. A technical group should oversee arrears liquidation to ensure the consistent application of the principles of the strategy. Some countries facing the challenge of clearing a significant stock of arrears have constituted an arrears committee in the ministry of finance. Such a committee should ensure that payments are made in accordance with the agreed prioritization criteria. This committee should comprise representatives from relevant departments, receive reports from spending units, and prepare periodic (for example, quarterly) reports to the ministry of finance and the Cabinet on the performance of entities on payment of arrears. The reports should highlight any non-reporting spending units and recommend remedial actions. Members of such a committee may include the budget department to ensure full adequate budgetary provision, the treasury to ensure cash availability for payments and reporting, the inspectorate or internal audit function within the ministry of finance to ensure proper procedures are followed, and possibly the supreme audit institution as an observer to ensure the integrity of the process.

The annual budget and medium-term budget framework (MTBF), if available, should make explicit provision for the clearance of arrears. Such measures may include the centralized management and control of the budget line for arrears repayment to avoid the recycling of arrears (paying old arrears while accumulating new ones). Any payment from this centralized budget should be backed by a list of verified eligible creditors, in line with the priorities of the repayment strategy.14 Entities should be required to provide this information to the ministry of finance for budget preparation, medium-term framework, performance monitoring, and budget release purposes, as well as verification against the database at the time of payment. If paid centrally, the amount of the central budgetary provision should be vired to those votes or budget lines for which the arrears have been paid and classified in accordance with GFSM 2001. Countries without an MTBF need to keep separate controls since the budget will show only the amount of arrears to be cleared in the budget year. A separate control on the remaining stock of arrears should be kept by the ministry of finance to ensure that sufficient provision is made in each subsequent annual budget until all arrears are paid.

14 The option to centralize control liquidation of arrears in the ministry of finance is the most usual strategy. However, a decentralized option may be adopted if the FMIS is well developed and the internal controls are of good quality.
Ensuring that payments are made according to the agreed strategy and schedule can be a challenge, especially where responsibility for payments is decentralized. Reports of payments made against the budget line for arrears in addition to regular fiscal reports will help to demonstrate the government’s commitment to the arrears clearance strategy and build confidence among suppliers in their subsequent dealings with government.

Generally, netting arrangements, such as offsetting the settlement of arrears to the private sector against tax obligations, are not advisable, as they undermine transparency and accountability and engender moral hazard. All payments and revenues must be accounted for on a gross basis. Any netting off of tax liabilities could undermine tax compliance and encourage the future accumulation of tax arrears. To avoid liquidity problems in its cash flow, the government may want to coordinate the payment to suppliers, with payment of their tax obligations to be concomitant, especially in the case of large amounts outstanding.

If fiscal space is available and the stock of arrears is small, the best option is to pay arrears in cash either from current receipts or government borrowing. This ensures that governments do not incur further financial penalties or interest and that enables suppliers to rebuild working capital.

The stock of arrears could be paid off immediately by borrowing in the domestic or foreign markets. The proceeds of the borrowing operations would be earmarked for the reduction of the stock of arrears. This option would increase the stock of government debt but would not decrease net worth, as government is explicitly recognizing a liability that existed as an implicit obligation to pay. But this option may not be feasible due to specific country restrictions, such as a gross public debt ceiling, because the domestic market is small, or it may be unaffordable because the cost of issuing sovereign debt is high.

If sufficient liquidity is not immediately available, governments may negotiate a schedule of payments with creditors according to a pre-defined calendar and an agreed interest rate. This option may be more viable if the stock of arrears is large and the current market conditions are not ripe for the placement of sizeable amounts of new debt, or if doing so would imperil other government short-term macroeconomic objectives. It may, however, impose a liquidity problem for some creditors that may be unable to wait for payment in tranches. As part of these negotiations, governments may agree to a discount, often termed a haircut; however, this approach should be treated with caution, since it can have the effect of increasing costs to the government, if suppliers inflate prices for further supplies in anticipation of an expected future discounting.

The securitization of the arrears, directly transforming them into government debt, should be considered only as a last resort. The range of securitization options includes issuing promissory notes (discountable by commercial banks that cannot be repurchased by the

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15 Securitization is further discussed in Ramos (1998).
central bank, as that would lead to monetization of the deficit), marketable treasury bills, or bonds directly to creditors. This approach has the advantage of allowing the government to select the debt maturity structure and repayment profile that best matches its financing needs. It also gives creditors the opportunity to raise liquidity by trading the titles in the secondary market, possibly at a discount. However, the direct securitization of arrears also has a number of disadvantages. First, experience of many countries suggests that securitization of unpaid bills creates strong moral hazard incentives for government financial managers to continue to commit resources in excess of available appropriations in the expectation that these will eventually also be securitized and paid centrally. Second, the securitized instruments almost always trade at a considerable discount which reduces the working capital available to the original supplier compared with cash payment. Third, securitization of the outstanding stock of arrears prevents the government from prioritizing payment of the most urgent arrears as securities are issued to all creditors on equal terms.

Finally, identifying and settling the stock of arrears between government and state-owned enterprises is necessary to avoid problems of solvency and profitability of enterprises. For government, a book entry can be made reflecting all outstanding bills, leaving a single remaining debt that can be resolved through an injection of funds in the state-owned enterprise from the budget and included in the MTBF. If reciprocal payments are owed to government, in the form of dividends for example, these can be netted off against the required cash injection.

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16 The discount on a treasury bill used for this purpose should only be the interest element. The discount on a promissory note may include a large element of risk premium relating to the likelihood of the government extending or refusing eventual payment to the discounter or purchaser of the note.
In 2003, the government of Angola defined a strategy to clear outstanding arrears accumulated since 1992 due to the civil war. Further measures were taken in 2013 to strengthen commitment controls and introduce a legal definition of arrears. The main features of the strategy were the following:

**Presentation of claims:** The government defined a time period for all creditors to present claims since 1992 on any entity of government. The government defined specific timetables and procedures for the arrears falling due over three time periods: 1992–1997, 1998–2003, and after 2003.

**Validation:** The ministry of finance hired an independent audit firm to assess each claim and validate its legitimacy.

**Negotiation:** After confirming the legitimacy of the claim, the government negotiated with each creditor and ratified the agreed amount due.

**Payment:** The government defined a uniform schedule of payment based on the amount due to each creditor. Part of the debt was paid in cash and part in treasury securities.

**Commitment controls and other reforms:** In 2013, the government started to introduce new procedures, including a centralized commitment control system, as part of an integrated financial management information system. All new investment projects should be included in the public investment plan, contracts should be preceded by a transparent bidding process as defined by the public contract law, and large contracts should be approved by the court of accounts before signature. The legislation includes the definition of arrears as 90 days and requires the co-signature of the minister of finance for any contract above US$ 0.5 million.

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## Appendix 1. Reform Priorities to Prevent Arrears

<table>
<thead>
<tr>
<th>Reform Area</th>
<th>Immediate Actions (Within one year)</th>
<th>Short-term Actions (One to three years)</th>
<th>Medium-term Actions (Ongoing)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal and regulatory framework</strong></td>
<td>Define in the legislation or regulation the number of days after which a due payment is considered in arrears.</td>
<td>Introduce a provision which requires government to pay interest where payment is delayed beyond the due date.</td>
<td>Define fiscal targets with appropriate escape clauses.</td>
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<td>Introduce requirements for commitment-based expenditure controls and the ministry of finance authorization prior to signature of high-value contracts.</td>
<td>Introduce the requirement for spending agencies and government as a whole to report on commitments, liabilities, revenues, payments, and arrears.</td>
<td>Introduce sanctions for the non-observation of fiscal targets, fiscal rules, or budget execution rules.</td>
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<tr>
<td></td>
<td>Clarify or strengthen sanctions for, among other things, commitments without appropriation, authorization, and accumulation of unpaid bills.</td>
<td>Ensure the law allows fiscal oversight of the whole of the public sector by the ministry of finance.</td>
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<tr>
<td><strong>Credibility and realism of the budget</strong></td>
<td>Conduct analysis of arrears-prone budget lines, and refine realistic budget envelopes, using historic expenditure data, where possible.</td>
<td>Introduce a costing system with an indication of standard costs for utilities and operating costs, such as information technology services, travel, utilities, and maintenance costs.</td>
<td>Introduce a medium-term fiscal framework that defines binding medium-term spending ceilings for each spending agency.</td>
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<td>Include in the budget and medium term budget framework a separate line to liquidate the stock of arrears. Prevent virement or reallocation from this line.</td>
<td>Implement an appraisal system for public investments.</td>
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<tr>
<td><strong>Government accounting</strong></td>
<td>Introduce quarterly reports to monitor expenditure arrears of central government by sector (ministries, agencies, extra-budgetary funds), including age analysis (less than 30 days, 30–60 days, 60–90 days, more than 90 days), of all liabilities, payments made in the period, and any new liabilities.</td>
<td>Expand the quarterly report to cover the arrears of general government.</td>
<td>Expand the quarterly reporting to cover the arrears of the non-financial public sector and eventually the entire public sector. Develop a plan for the implementation of accrual accounting.</td>
</tr>
<tr>
<td><strong>Fiscal reporting and transparency</strong></td>
<td>Increase the coverage of fiscal reporting, including all central government spending agencies and extra-budgetary entities.</td>
<td>Further expand coverage of fiscal reports (biannually initially) to the general government sector.</td>
<td>Increase coverage of reports to the public sector.</td>
</tr>
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<td></td>
<td>Publish quarterly reports with information on commitments, payments, and arrears.</td>
<td>Publish on the internet a summary of all contracts, including supplier, value, and expected output.</td>
<td>Publish details of commitments and payments of all contracts, including supplier information and non-commercial terms of contracts.</td>
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<td>Increase the frequency of fiscal reporting to monthly.</td>
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<tr>
<td>Reform Area</td>
<td>Immediate Actions (Within one year)</td>
<td>Short-term Actions (One to three years)</td>
<td>Medium-term Actions (Ongoing)</td>
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<tr>
<td>Cash management</td>
<td>Introduce quarterly cash planning by spending agencies to guide expenditure ceilings. Allow spending outside of cash plan only under specific circumstances.</td>
<td>Expand coverage of cash plan to one year rolling plan and gradually increase its accuracy through trend analysis. Implement/expand coverage of the TSA.</td>
<td>Develop more active cash management and enhance links to the debt management framework.</td>
</tr>
<tr>
<td>Institutional framework</td>
<td>Define roles and responsibilities of the ministry of finance: Allow fiscal oversight by the ministry of finance of all central government spending agencies, and include extra-budgetary and autonomous agencies, subnational governments, and state-owned enterprises.</td>
<td>Include payment of creditors in a timely manner in the corporate governance framework of state-owned enterprises.</td>
<td>Ensure at least quarterly monitoring of state-owned enterprises and autonomous agencies, with a particular emphasis on liabilities.</td>
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<td></td>
<td>Involve external audit: Request that the external audit conduct audits of ministries generating significant arrears, and verify the completeness of liabilities reported, including age of accounts payable.</td>
<td><strong>Involve internal audit</strong>: Create internal audit units in line ministries where arrears are known to be a problem; ensure arrears and commitment controls are included in internal audit work plans.</td>
<td><strong>Strengthen the value for money auditing capacity within internal and external audits.</strong></td>
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<tr>
<td>Internal controls</td>
<td>Introduce an obligation that commitment numbers generated by the FMIS are included in all contracts.</td>
<td>Ensure that goods and services are delivered according to contract terms and that payment amounts are correct and made on time and with proper authority.</td>
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<td></td>
<td>Reconcile payments made by spending agencies with utility bills to avoid the accumulation of unpaid bills.</td>
<td>Perform timely inspections to ensure that the implementation of investment projects is according to contract specifications before stage payments are made.</td>
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<td>Introduce annual and multi-year commitment controls for large contracts.</td>
<td>Expand multi-year commitment controls to medium-value contracts.</td>
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<td>Introduce pre-paid electricity and telephone cards, and allow services to be suspended in case of default.</td>
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<td>Financial Management Information System</td>
<td>Introduce commitment control system; identify commitments through unique numbers for purchase orders generated by the FMIS and forbid contracts from being signed without the commitment numbers.</td>
<td>Ensure that the FMIS system can capture the due date of all payments and can generate reports on all liabilities by age.</td>
<td>Expand the FMIS to the entire central government.</td>
</tr>
</tbody>
</table>
## Appendix 2. Sample Measures Adopted by Countries to Address the Accumulation of Arrears

<table>
<thead>
<tr>
<th>Country</th>
<th>Main Problems</th>
<th>Corrective Measures Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Albania (2002)</strong></td>
<td>• Inter-enterprise arrears and arrears to the tax and social security systems.</td>
<td>• Record inter-enterprise arrears and tax arrears.</td>
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<td>• Complete reconciliation process.</td>
<td>• Complete reconciliation process.</td>
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<td>• Sign bilateral memoranda of understanding indicating the amount of net overdue payables/receivables.</td>
<td>• Sign bilateral memoranda of understanding indicating the amount of net overdue payables/receivables.</td>
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<td>• Determine the amount that can be canceled through multilateral nettings.</td>
<td>• Determine the amount that can be canceled through multilateral nettings.</td>
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<tr>
<td><strong>Angola (2009, 2013)</strong></td>
<td>• Arrears accumulated during civil war and financial crisis.</td>
<td>• Undertake census of arrears and audit of claims.</td>
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<td></td>
<td>• Sharp reduction of revenues from oil.</td>
<td>• Define a payment calendar.</td>
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<td>• Low demand for treasury papers.</td>
<td>• Reach agreement with creditors.</td>
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<td>• Extra-budgetary expenditures and weak commitment controls.</td>
<td>• Implement temporary suspension of new contracts.</td>
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<tr>
<td></td>
<td></td>
<td>• Create commitment control system.</td>
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<td></td>
<td>• Include definition of arrears in legislation.</td>
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<tr>
<td><strong>Central African Republic (2012)</strong></td>
<td>• Excess expenditures outside of the budget system.</td>
<td>• Conduct audit to identify and certify the expenditure arrears, and develop plan to clear arrears.</td>
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<td></td>
<td>• Strengthen budget execution and public financial management through spending controls and transparent recording of expenditure and domestic revenues, with a view to generating surplus on the domestic primary balance.</td>
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<td></td>
<td>• Set expenditure commitment ceilings consistent with available liquidity.</td>
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<td></td>
<td>• Create a Liquidity Committee and a Budget Management Monitoring Committee.</td>
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<td></td>
<td>• Limit extra-budgetary payments.</td>
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<tr>
<td><strong>Republic of Congo (2004)</strong></td>
<td>• Lower-than-expected non-oil revenue receipts, (higher-than-expected transfer and subsidy expenditures).</td>
<td>• Develop clear definition of payment arrears.</td>
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<td></td>
<td>• Non-programmed payments of domestic arrears due to reconstruction investments, the sale of government oil through the national oil company at prices below reference prices.</td>
<td>• Obtain validation by the Office of the Inspector-General of Finance and the Court of Accounts of the stock of arrears on social debts (wages, pensions, and the rights of workers in liquidated enterprises).</td>
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<td></td>
<td>• Inefficient cash flow management.</td>
<td>• Close retirement fund accounts and Treasury deposit accounts.</td>
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<td>• Establish payment methods and schedules.</td>
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<td>• Implement a system to ensure the integrity of ex post settlement of arrears.</td>
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<td>• Prepare a preliminary table of cross debts at end-2003 (government, social security, public enterprises, and private sector). These cross debts will be audited by an independent firm.</td>
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<tr>
<td>Country</td>
<td>Main Problems</td>
<td>Corrective Measures Proposed</td>
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</tbody>
</table>
| Côte d'Ivoire (2002) | • Accumulation of arrears between the government and the energy sector.  
• Control of energy tariffs affecting the financial sustainability of the energy companies. | • Adoption of a settlement plan for domestic payments arrears.  
• Settlement of claims and debts between the government and energy sector.  
• Implementation of recommendations of the study on electricity tariffs. |
| Côte d'Ivoire (2011) | • Accumulation of external debt with bilateral and multilateral creditors.  
• Accumulation of arrears between public enterprises and the social security system. | • Application of a plan for clearing arrears, validated jointly by the public enterprises and social security institutions. |
• Arrears accumulated to domestic and external creditors.  
• Wage arrears related to unpaid financial impact of advancement promotion of civil servants. | • Restructure public enterprises.  
• Negotiate a reschedule on payments of debt obligations to external creditors.  
• Audit unpaid payment orders.  
• Improve budgetary transparency and reporting on budget execution including arrears. |
| The Gambia (2002) | • Reemergence of cross arrears between the government and public enterprises, including tax arrears. | • Develop and implement a comprehensive program to address the financial problems of the public enterprises and a settlement of inter-entity arrears.  
• Define quarterly targets to eliminate cross arrears by addressing longer-term financial imbalances of public enterprises, including restructuring or privatization. |
| Georgia (2004) | • Significant increase in fiscal deficits, leading to a buildup in domestic arrears on pensions and wages.  
• Unrealistic budget and weak expenditure management.  
• Poor governance in tax collection. | • Define a plan to clear and reschedule payment obligations.  
• Audit the stock of arrears and the register of pensioners.  
• Implement a treasury single account and a full commitment control.  
• Prepare realistic monthly cash plans and a more predictable schedule for treasury bill auctions.  
• Implement civil service reforms to improve quality and reduce corruption.  
• Introduce and enforce disciplinary and ethic codes.  
• Prepare monthly commitment, arrears, and payment reports. |
| Ghana (2003)  | • Accumulation of arrears regarding road contracts, education allowances, and other expenditures.  
• Unrealistic public services tariffs, leading to financial constraints of the public enterprises in water and electricity.  
• Accumulation of cross-company debts. | • Implement a new commitment and cash management system and a budget accounting system on a pilot basis.  
• Prepare monthly early warning report to identify eventual accumulation of arrears.  
• Implement automatic pricing formula on the price of oil.  
• Audit to determine amount of cross-debt among public service utility companies.  
• Implement monthly report on commitments and arrears. |
<table>
<thead>
<tr>
<th>Country</th>
<th>Main Problems</th>
<th>Corrective Measures Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ghana (2009)</td>
<td>• Larger fiscal deficit and insufficient financing.</td>
<td>• Take stock of the accumulated arrears.</td>
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<tr>
<td></td>
<td>• Institutional capacity to identify and control the accumulation of new arrears, and difficulties in rolling out the accounting system to all entities.</td>
<td>• Implement financial recovery plan in public enterprises and a cost-recovery price strategy.</td>
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<td></td>
<td>• Strengthen the public expenditure monitoring function.</td>
<td>• Establish a cash management framework and an early warning system.</td>
</tr>
<tr>
<td>Haiti (2006)</td>
<td>• Accumulation of wage and non-wage arrears.</td>
<td>• Improve fiscal transparency, and prepare a census on government employees and a survey on wage arrears.</td>
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<td></td>
<td>• Implement plan for clearance of wage arrears.</td>
<td>• Implement plan for clearance of wage arrears.</td>
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<tr>
<td>Lesotho (2010)</td>
<td>• Lack of adequate implementation of a financial management information system to control expenditure execution and to implement adequate internal controls and reporting functions.</td>
<td>• Improve effectiveness of the integrated financial management information system.</td>
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<td></td>
<td>• Audit to identify arrears.</td>
<td>• Audit to identify arrears.</td>
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<tr>
<td>Malawi (2005)</td>
<td>• Cost overruns in construction of roads beyond contract estimates and budget ceilings.</td>
<td>• Define an arrears policy.</td>
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<td>• Accounts payable module of the information system not operational.</td>
<td>• Implement new public audit act and public finance management act.</td>
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<td>• Insufficient internal mechanisms to control arrears.</td>
<td>• Implement administrative measures to prevent arrears on utility expenses.</td>
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<td>• Inclusion of teachers in payroll without budget provision.</td>
<td>• Securitize stock of arrears through issuance of special treasury bills.</td>
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<tr>
<td></td>
<td>• Implement the commitment control module of the financial management information system.</td>
<td>• Publish monthly report on arrears.</td>
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<td>• Inform suppliers that expenditures outside of the system will not be paid.</td>
<td>• Introduce pre-payment system for telephones.</td>
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<tr>
<td></td>
<td>• Implement direct payment by accountant general of utility bills and offsetting of departmental budget transfers.</td>
<td>• Implement direct payment by accountant general of utility bills and offsetting of departmental budget transfers.</td>
</tr>
<tr>
<td>Malawi (2012)</td>
<td>• Sharp reduction in external grants, leading to increasing fiscal deficits.</td>
<td>• Audit arrears claims.</td>
</tr>
<tr>
<td></td>
<td>• Tariffs charged by public enterprises below recovery cost.</td>
<td>• Implement the commitment control module of the financial management information system.</td>
</tr>
<tr>
<td></td>
<td>• Inform suppliers that expenditures outside of the system will not be paid.</td>
<td>• Inform suppliers that expenditures outside of the system will not be paid.</td>
</tr>
<tr>
<td>Niger (2005)</td>
<td>• Shortfall in external financing and higher fiscal deficit.</td>
<td>• Define an arrears clearance strategy.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Prioritize payment of wage arrears.</td>
</tr>
</tbody>
</table>

References


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Fiscal Affairs Department