

# Republic of Chile

## COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT

2004

Operations Support Unit  
Latin America and the Caribbean Region

The World Bank

Inter-American Development Bank



Document of the World Bank and Inter-American Development Bank

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**REPUBLIC OF CHILE –FISCAL YEAR**

January 1 – December 31

**CURRENCY EQUIVALENTS**

Currency Unit = Ch Peso

US\$1 = 690 Ch Peso

**WEIGHTS AND MEASURES**

Metric System

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**ABBREVIATIONS AND ACRONYMS**

|          |  |
|----------|--|
| BCH      | Central Bank of Chile  |
| CAIGG    | Council for General Government Internal Auditing                               |
| CAS      | Country Assistance Strategy  |
| CFAA     | Country Financial Accountability Assessment                                    |
| CGR      | Controller General of the Republic   |
| CODELCO  | State Copper Company   |
| CORFO    | Production Development Corporation   |
| CPIA     | County Policy and Institutional Assessment                                     |
| CUF      | Single Revenue Account   |
| DIPRES   | National Budget Office   |
| DMFAS    | Debt Management System (Spanish: SIGADE)                                       |
| ENAMI    | National Mining Company  |
| ENAP     | National Petroleum Company   |
| FCC      | Fondo Común Competitivo  |
| FONASA   | National Health Fund   |
| GAGAS    | Generally Accepted Government Auditing Standard                                |
| GFSM     | Government Financial Statistics Millennium                                     |
| IAU      | Internal Audit Unit  |
| IDB      | Inter-American Development Bank  |
| IMF      | International Monetary Fund  |
| INDAP    | Agricultural Development Institute   |
| INTOSAI  | International Organization of Supreme Audit Institutions                       |
| LAFE     | Framework Law for Financial Administration                                     |
| MIDEPLAN | Ministry of Planning   |
| MOF      | Ministry of Finance  |
| MTEF     | Mid-Term Expenditure Framework   |
| NAO      | National Audit Office  |
| OECD     | Organization of Economic Cooperation and Development                           |
| PFM      | Public Financial Management  |
| PMG      | Management Improvement Programs  |
| ROSC     | Report on Standards and Codes  |
| SA       | Service Agency   |
| SAI      | Supreme Audit Institution  |
| SEP      | System of Public Enterprises   |
| SIAPER   | Personnel Management System  |
| SICOGEN  | General Accounting System of the CGR   |
| SIAP     | Budget Control System in DIPRES  |
| SIGFE    | Integrated Financial Management System   |
| SIGADE   | Integrated External Debt Management and Administration System (English: DMFAS) |
| SOE      | State Owned Enterprises  |
| SUBDERE  | Undersecretary of Regional and Administrative Development                      |
| SVS      | Superintendence of Securities and Insurance                                    |
| VUOP     | Housing, Urban and Public Works Division of the CGR                            |
| WB       | World Bank   |

## ACKNOWLEDGMENTS

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## EXECUTIVE SUMMARY

Chile is an upper- to middle-income country of 15.4 million people with the most robust economic performance in the Latin America region. GDP was US\$ 72.4 billion in 2003 and per capita income<sup>1</sup> US\$ 4,390, one of the highest in Latin America. Chile's macroeconomic policies and strong fundamentals have, to a large extent, insulated it from regional crises and have allowed continued growth in recent years, albeit at lower rates than in the mid-1990s. Economic performance continues to outpace that of the rest of the Region, and in per capita terms, GDP growth has averaged 4 percent per year since 1990, versus 1 percent for the LAC region during the same period.

This performance is sustained by sound policies and an ambitious structural reform agenda. Public sector reforms of the 1990's resulted in a considerable improvement in public finance, health, education and social security, with emphasis on good and expeditious delivery of services to citizens. In early 2003, the Government and the opposition agreed to a national proposal to modernize state institutions, ensure greater transparency, prevent corruption, and stimulate growth. The main elements of the reform package are: a reform of the civil service regime, including the introduction of performance-based incentives and reduction of political appointees in the senior executive service; an expediting and simplification of administrative procedures to reduce the uncertainty for the private sector in its dealings with the public sector; a public procurement law, establishing an electronic procurement and information system, and increasing the transparency of government contracts for the purchase or lease of goods; and a package of measures to increase government transparency, the most important of which is campaign finance reform, setting limits on electoral spending, and making political financing more transparent and subject to external controls.

Transparency International assigned Chile a 7.5 corruption perception rating compared to an average of 3.4 for the LAC region (a rating of 10 corresponds to public perception of zero corruption). Central public sector institutions score high in economic management, structural policies, and overall public sector management, out-ranking regional counterparts and income group comparators.

### Overview of Public Financial Management in Chile

The abundant trust in government in Chile today can be attributed, in part, to two elements of transparency: its fiscal reporting and the incontestable review by a competent, independent authority – the CGR

The relationship between good governance and better economic and social outcomes is increasingly acknowledged. Transparency - openness about policy intentions, formulating and implementation - is a key element of good governance. The budget is the single most

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<sup>1</sup> Per capita Gross National Income, Atlas method.

important policy document of governments, where policy objectives are reconciled and implemented in concrete terms. Budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic matter. Recognizing this relationship, in Chile the executive has made a formal commitment with Congress to conform with the OECD Best Practices for Budget Transparency.<sup>2</sup>

Furthermore, Chile has effectively centralized policies and procedures to support aggregate fiscal discipline. Aggregate fiscal discipline, measured by total fiscal balance or public debt, and the related predictable funding of the budget in Chile has been achieved through a well-developed budget system which provides for a realistic and comprehensive budget.

The management of service delivery and the corresponding financial operations, on the other hand, is delegated to 190 administratively independent service agencies. The main feature of Chile's public financial management (PFM) operations has been the combination of centralized policies and procedures operated by DIPRES and CGR with decentralized service delivery and financial management operations through 190 service agencies. Although now the subject of a significant reform, DIPRES and CGR use separate, unintegrated processes to monitor budget implementation and prepare the financial statements of the central government.

With the development of a centralized integrated financial management system (SIGFE), the strengthening of internal controls in the service agencies and the modernization of the external audit system, all supported by substantial investment projects from the World Bank and the Inter-American Development Bank, the centralized control can now continue to evolve to greater reliance on accountability for results, with a focus on outputs rather than inputs by the agencies. These developments also allow the functional specialization of the two rector entities of financial management system - DIPRES and CGR – which now have overlapping functions, which is the case of the CGR, some functions that are incompatible with its ultimate responsibility as the system's external auditor.

#### Distinguishing Feature of PFM in Chile

Chile's public financial management is characterized by a unique blend of strengths and weakness. At present, the systems to support the budgeting and accounting in the public sector operating at the agency level are not state-of-the-art and are not uniform across the public sector since they are the responsibility of each executing agency. The systems in place centrally to support fiscal discipline, efficiency and external reporting are not state of the art and duplicative between DIPRES and CGR.

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<sup>2</sup> OECD Member countries are at the forefront of budget transparency practices and drew together a set of Best Practices in this area based on Member countries' experiences. The Best Practices are designed as a reference tool for Member and non-member countries to use in order to increase the degree of budget transparency in their respective countries.

Despite these limited systems, Chile scores high on financial management outputs in fiscal discipline, transparency and supporting efficiency in operations because underlying all financial management operations are clear rules, strict adherence to the rules, dedicated and qualified staff and management which rewards ethical and efficient behavior and there is a matching of responsibility with accountability given the decentralization of financial management to the service agencies.

As such, Chile has in place the two elements<sup>3</sup> of effective controls systems: workable rules and procedures; and patterns of behavior that accept the rules and procedures as legitimate.

It is precisely this solid basis of clear rules and behavior in line with the rules that will allow Chile to attain the standards of public financial management which it has targeted (accrual based fiscal reporting and OECD Budget Practices) but it must address remaining issues on the implementation of the new systems and produce an explicit audit opinion on the general government sector financial reports.

## **Summary of the Financial Accountability Arrangements**

### Institutional Arrangements

**The legal framework for public financial management rests first, on a clear definition of roles between the legislature, the executive, and the autonomous external audit institution (CGR).** Furthermore, the responsibility for planning, controlling and reporting of funds is set out in the law; responsibilities for treasury, budgeting and accounting are assigned to specific central authorities (Treasury, National Budget Office and the CGR, respectively).

Compliance with the legal framework on public financial management is encouraged in Chile by the independent oversight provided by the CGR and intervention by the other central authorities – DIPRES, National Civil Service Commission, Council for General Government Internal Auditing (CAIGG). Compliance with this framework is also encouraged through laws on probity which render personnel of the state administration subject to administrative responsibility for their acts in addition to civil and criminal responsible.

### Budget Development

**Chile has a well-developed budget system which provides for a realistic and comprehensive budget, developed and implemented according to a well-defined timetable and processes. There is also a high level of budget transparency.**

Chile also has a strong track record of fiscal prudence. Current fiscal policy (a political commitment of the Government, rather than a legal requirement<sup>4</sup> provides for a

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<sup>3</sup>A Contemporary Approach to Public Expenditure Management, Allen Schick, World Bank Institute, 1999

*structural* (i.e. underlying, or excluding the impact of short-term output fluctuations and deviations of the copper price from its long-run estimated mean) budget surplus of one percent of GDP. Necessary adjustments to achieve this target are made to budget expenditures during the year. This structural target has enabled the Government to pursue counter-cyclical economic policies in recent years.

Chile makes extensive use of performance information in the budget process; under the decentralization of financial management, performance measures and program evaluations are key to align incentives with budget objectives and facilitate supervision by central authorities. This occurs through two main mechanisms, managed through a separate unit of DIPRES : (1) a system of performance indicators developed for ministries and agencies, and (2) a system of program evaluations.

Two exceptions to the comprehensive nature of the budget, however, should be noted:

- A transfer of 10 percent of the gross revenues of the national copper company, CODELCO, to the ministry of defense for allocation to the three services for equipment purchases, which is provided for in the reserved copper law.<sup>5</sup> This arrangement is an exception to the general prohibition on earmarking of revenues contained in the constitution. Aggregate information on this expenditure is contained in the public finance statistics and the quarterly budget execution reports.

- Significant quasi-fiscal activity is undertaken by the state-owned commercial bank, Banco Del Estado, which has the exclusive right to hold public funds, although there is no reliable estimate of the amount of this activity. The bank does not pay interest on the balances in the estimated near 5,000 ministry and agency bank accounts (with average daily balances of between US\$500 million and \$800 million), but in return provides government banking services at no charge and social services such as maintaining unprofitable branches in rural areas and providing particular services for poor people.

### Budget Implementation

**Budget implementation is supported by predictable funding, achieved through effective cash allotting and tight budget monitoring, which at present depends on the stand alone budget and accounting systems in the service agencies but is closely overseen by central authorities through the ex-ante review in the CGR and the regular reporting to DIPRES and CGR.**

The systems in the service agencies are not integrated with those of agency headquarters and only report on net movement by account and only in hard copy or in text files to the central authorities (DIPRES and CGR). These systems do not provide control over the budget commitment process and contribute to the diffusion of government bank accounts.

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<sup>4</sup> According to information received from the Chilean Government in April 2005, the recent amendments of LAFE reinforce the legal framework of the budget system

<sup>5</sup> CODELCO's total export revenue for 2003 came to \$ USD 3.8 billion.

The centralized system SIAF in DIPRES for budgeting and SICOGEN in CGR for budgeting and accounting are not state of the art, duplicative and not integrated with those subsidiary systems in the service agencies.

An integrated financial management system (SIGFE) is under implementation to address this and supports the current decentralization of financial management to the service agencies. At the same time, it provides central authorities with a uniform and reliable process in which a consolidated budget, including commitments, and accounting information is generated by providing central authorities with on-line access to transaction information.

Given the role of SIGFE in the aggregate budget control and financial reporting, the steps to cover the outputs of SIAP and SICOGEN and the arrangements for the operation of the centralized applications should be agreed upon well in advance of the 2005 deadline for full conversion to SIGFE. Steps toward this end would begin with settling which entity will operate the centralized SIGFE application; a sign-off that its provisions comply with the reporting needs of both the CGR and DIPRES and an explicit commitment to rely on SIGFE once implemented.

#### Fiscal Transparency

**(i) Fiscal reporting is timely and comprehensive, and much of it is available publicly on government websites.** The draft budget law provides comprehensive information covering the main fiscal aggregates and monthly, quarterly, and annual budget execution reports are published within 45 days of each period's end. Public Finance Statistics are also presented in a Public Finances Yearbook published around April each year, with comparative information being provided for the previous nine years.

**(ii) The Government's annual financial report, prepared by CGR, is timely, comprehensive, and reliable, and it is generated in an environment of good internal control with regular ongoing external oversight by the CGR.**

These statements could be improved however: the notes to the financial statements are incomplete, there is no operating statement to explain changes in net worth between years, significant entities are excluded, including the State Copper Company, CODELCO, and the report is not accompanied by an audit opinion. Virtually all the information missing from the annual financial report is disclosed by DIPRES elsewhere, so it would be a small step to include this in the annual financial report. These statements would present for all stakeholders, statements fully in line with disclosure conventions implied in generally accepted accounting standards, thus facilitating analysis of the results and of the financial position of the state.

#### Internal Control and Internal Audit

**Chile is well advanced in the adoption of the modern concept of internal control as a management responsibility and as a basis for performance-based government. Since**

1997 it has achieved positive results in internal control and audit, and is making progress in the use and assessment of internal controls.

Presidential decrees and central overview of the internal audit function in ministries, agencies and public enterprises have assisted in the creation of a culture of positive control. The fundamental components of internal control (planning, implementing, supervising and monitoring) are also embodied in the Management Improvement Programs developed by each agency. Advising management on areas at risk, performing audits of operations and recommending ways to improve operations and strengthen internal controls are becoming an integral part of the work of the internal auditors.

### External Audit and Review

**The external control function for Chile's public sector is the responsibility of the CGR, a well-respected institution which has played an important role in strengthening public financial management in Chile and in helping to build Chile's justifiably high reputation for probity and fiscal transparency.** The CGR has many functions (pre-audit review, vetting of legislation, setting accounting standards, preparing the financial statements of the public sector, and external audit), not all of which are compatible with the role of a modern external public audit institution. CGR has progressively relaxed its ex-ante control systems. With the growing maturity of internal controls within the Chilean public sector as internal audit units become more developed and as Ministry of Finance-led control systems, for example SIGFE and SIAPER (Personnel Management System), come to fruition, the CGR should consider further reductions in ex-ante controls and build up a broader range of ex-post audit and evaluation activities. This evolution in functions would provide the independence and the time required for issuing opinions on the published financial statements. This would reinforce the transparency and the separation of duties within Chilean Public Finance institutions.

**The CGR does not provide opinions on the consolidated financial accounts or on individual agency financial statements.** Assessing the extent to which the accounts of government bodies in Chile are true and fair would exert a useful discipline on public entities in Chile, encouraging accounts to be completed promptly and accurately. Such opinions are consistent with principles of transparency embedded in the public sector modernization agenda of the government and the Congress and would buttress Chile's international reputation for propriety. To position itself to render an opinion on the consolidated financial statements, the CGR would have to distance itself from the preparation of the statements, which would require a Constitutional amendment.

### **Conclusion**

**Chile is well into the second generation of public sector reforms.** The current focus has moved beyond fiscal discipline to improving public service delivery, that is, the effectiveness and efficiency of government. Such improvements can be built now only because they can rest on the solid existing base of (i) fiscal stability, (ii) predictable

financing, and (iii) resource use in line with budget authorizations, with reliable reporting on income, uses and financial position.

In Chile, the assurance that uses of public funds are in line with authorizations and that there is full and accurate reporting is attributed to clear roles set in law for the executive and the legislature on budget development and oversight, and a clear definition of the responsibilities within the executive for financial management. These roles and rules on the use of public funds are strictly observed and are supported through:

- An obvious commitment by public sector management to efficiency and transparency in the public sector.
- Incentives in the government-wide Management Improvement Program for building financial management capacity in the service agencies.
- Staffing of financial management positions with qualified professionals in the respective disciplines who operate under clear written rules and regular expert supervision.
- Independent review by internal auditors under the control of the management of each agency, internal auditors under the Executive, and external auditors reporting to agency management, the Executive and to Congress on the legal compliance and probity of all administrative acts.
- Decentralization of financial management to the service agencies, accompanied by well-developed performance measures.

#### Unresolved Issues

Notwithstanding the favorable status of financial management, to advance with modernization toward the world's most advanced countries in terms of fiscal transparency<sup>6</sup>, the following issues have to be addressed.

#### **SIGFE**

Chile is committed to moving to accrual based fiscal reporting (GFSM2001)<sup>7</sup>. In turn, the steps to prepare Chile for accrual based fiscal reporting involve the successful implementation of the integrated financial management (SIGFE), under development, both at the decentralized level and centrally for aggregation and oversight.

Given that a single system now integrates accounting, budget and treasury, there is a general understanding that a single party must be responsible for the operation of the system and that the existing separate systems must be displaced by SIGFE. There is, however, no formal commitment to this and no detailed steps have been laid out for its implementation.

Given CGR's constitutional responsibilities for keeping the accounts of the nation it has to be satisfied that SIGFE meets these ends and has to ensure that it is operating to their

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<sup>6</sup> The Director of DIPRES summed up Chile's position on financial management reform in the Report on Government Finances (2003): THE AIM IS TO RAISE CHILE TO THE SAME LEVEL AS THE WORLD'S MOST ADVANCED COUNTRIES IN THE QUESTION OF FISCAL TRANSPARENCY STANDARDS.

<sup>7</sup> IMF (2003), Chile-Staff Report for the Article IV Consultation, paragraphs 29 and 50 and Annex II.

expectation on an on-going basis. At the same time, the executive (DIPRES) has a duty to maintain a financial administration information system and control the budget.

Since DIPRES is responsible for maintaining a financial administration system, it would follow that they operate SIGFE. Arrangements could foresee that (i) DIPRES operate SIGFE and (ii) DIPRES and CGR would have simultaneous real time access to SIGFE data. Under these, or similar arrangements, a detailed formal plan should be formalized so the arrangements for implementation of the centralized system may be effected. These arrangements would be operational and would not change the responsibilities upon accounting function defined by the Constitution.

#### Project Administration Mainstreaming

A concrete short term benefit of the full implementation of SIGFE is the possibility for the administration of investment project financed by the international financial institutions to be carried out exclusively through the financial management system of the Service Agencies. This mainstreaming of project administration offers efficiencies and economies to the Government in that no redundant systems are developed or operated for the individual projects.

#### External Audit

OECD Best Budget Practices cover not only the principal budget reports that governments should produce and their general content but also the practices for ensuring the quality and integrity of the reports. In this regard, Chile is at a variance with the external auditing best practice which states “The year-end report should be audited by the Supreme Audit Institution in accordance with generally accepted auditing practices.”

For Chile to emerge at the forefront of public sector management, it should issue its annual financial statements with an audit opinion and move to closer adherence with internationally accounting standards in its reporting. The lack of any external audit opinion on the government financial statements is not consistent with a modern approach to public sector external auditing. The independent review is a central pillar of transparency; a key output of the external review is an explicit audit opinion on the financial reports of the general government entities. The accepted medium for expressing the results of this work is to attach the auditor’s opinion, in a format and of a content which conform to international auditing standards, to the financial statements so that users of these statements have this comfort when viewing the statements.

To render these opinions, CGR would have to distance itself from both the ex ante approval role of budget uses and the preparation of the annual financial statements. This potential conflict of interest between the preparation of accounts by CGR and their role in the audit of these accounts does not comply with INTOSAI principles. However, modifying CGR mandate and activities may be difficult, in part because CGR has a strong reputation, and in other part because of role ascribed to CGR in the Constitution. The Chilean authorities should therefore consider a solution that complies with international practice and accommodate with country constraints.

### Financial Management Risk

The financial management arrangements in place (clear roles and rules, transparent reporting, good independent oversight, sophisticated budget techniques and decentralization of financial management to the agencies) clearly align with the Government's goals of fiscal stability and greater efficiency in service delivery. These arrangements also indicate that the financial management risk to Bank funds, indeed to public funds in general, is low.

# 1. BACKGROUND

## COUNTRY BACKGROUND

### Economic Context

1.1. Chile is an upper- to middle-income country of 15.4 million people with the most robust economic performance in the Latin America region. GDP was \$US 72.4 billion in 2003 and per capita income<sup>8</sup> \$US 4,390, one of the highest in Latin America. Chile's macroeconomic policies and strong fundamentals have, to a large extent, insulated it from regional crises and have allowed continued growth in recent years, albeit at lower rates than in the mid-1990s. Economic performance continues to outpace that of the rest of the Region, and in per capita terms, GDP growth has averaged 4 percent per year since 1990, versus 1 percent for the LAC region during the same period.

1.2. This performance is sustained by sound policies and an ambitious structural reform agenda. The country's fiscal position is strong, and public external debt is low, standing at 12 percent in 2003. A flexible exchange rate and inflation targeting are implemented by an independent central bank, and the financial sector is healthy and solvent, having weathered well the economic slowdown since 1998 as well as various emerging market crises. Chile's significant advances in negotiating free trade agreements have helped bolster its external sector. Reflecting these generally positive conditions, Chile's country risk premium has declined to 70 basis points, the lowest of any Latin American country; Chile's foreign-currency debt rating was raised by Standard & Poor's from A- to A in January 2004, and is now four notches above that of Mexico, Latin America's only other investment grade-rated country.

### Modernization of the State

1.3. Chile is rated highly on law and order and the quality of its bureaucracy, and low on levels of corruption. Transparency International assigned Chile a 7.5 corruption perception rating compared to an average of 3.4 for the LAC region (a rating of 10 corresponds to public perception of zero corruption). Central public sector institutions score high in economic management, structural policies, and overall public sector management, out-ranking regional counterparts and income group comparators.

1.4. To buttress its foundations for growth, Chile has continued to promote an impressive reform agenda. The list of structural reforms, many already approved and under implementation, covers a gamut of topics, including: state modernization and transparency, regulatory reforms to spur investment and growth, enhanced financial regulation and supervision, labor market measures, and a recent flock of Free Trade Agreements (FTAs).

1.5. Public sector reforms of the 1990's resulted in a considerable improvement in public finance, health, education and social security, with emphasis on good and expeditious delivery of services to citizens. In early 2003, the Government and the opposition agreed to a national proposal to modernize state institutions, ensure greater transparency, halt corruption, and stimulate

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<sup>8</sup> Per capita Gross National Income, Atlas method.

growth. Between March and May of 2003, the Government took to Congress a package of nearly 50 measures largely related to public sector reform and with a heavy emphasis on state modernization and transparency.

1.6. The main elements of the reform package are: a reform of the civil service regime, including the introduction of performance-based incentives and reduction of political appointees in the senior executive service; an expediting and simplification of administrative procedures to reduce the uncertainty for the private sector in its dealings with the public sector; a public procurement law, establishing an electronic procurement and information system, and increasing the transparency of government contracts for the purchase or lease of goods; and a package of measures to increase government transparency, the most important of which is campaign finance reform, setting limits on electoral spending, and making political financing more transparent and subject to external controls.

### **OBJECTIVE OF THE CFAA**

1.7. The CFAA supports the Banks' *development objectives* by identifying strengths and weaknesses in country PFM systems. It facilitates a common understanding among the government and the Banks on the performance of the institutions responsible for managing the country's public finances. Also, the information obtained in CFAAs helps the government and Participating Banks to meet their *fiduciary objectives* by identifying risks to the use of public funds posed by weaknesses in public financial management arrangements. This is the first assessment (CFAA) by the Banks of Chile; it follows closely and has made extensive use of factual information contained in two earlier reports: Chile: Report on the Observance of Standards and Codes – Fiscal Transparency Module, IMF, August 2003, and an OECD report, Budgeting In Chile (2004).

1.8. On the fiduciary objectives, the outputs of the CFAA are pertinent to determining the reliance which can be placed on country-wide systems for investment projects and to provide a fiduciary framework for development policy lending i.e. where loan proceeds are not traced to specific expenditures. On the development objectives, while Chile's fiscal performance is proof of the capacity of its public expenditure management arrangements, this capacity continues to grow with the implementation of well-focused reforms and the high profile given to performance issues in the budget discussion. Chile is seeking evaluation of its public financial management performance as it undertakes to come astride the OECD countries in its budgetary practices and fiscal reporting. Therefore, in addition to the fiduciary assessment, this CFAA's compares what is being accomplished and the plans of the reforms against what is needed to reach the stated goals in financial management.

### **Issues Influencing the Coverage and Scope of the CFAA**

1.9. Reforms and initiatives in public sector budgeting in Chile include the use of multiyear forecasts, a fiscal surplus rule, and performance measurements and budgeting on the basis of outcomes and results evaluations. In this context of a well-performing public sector and good reform record, the two issues required particular attention in the CFAA.

1.10. **Decentralization.** The current degree of decentralization of budget execution, accounting and cash management presents a challenge for the CFAA. While decisions on the level of spending

and the allocation by sector may be centralized, the management of service delivery and the corresponding financial operations are spread over 190 administratively independent agencies. The only transaction-level records of public sector spending are kept in these agencies. The central authorities cannot guarantee the integrity of the information received as they apply only analytical tests to the input. Reforms to provide uniform systems for these operations are, however, underway.

1.11. ***Focus on Central Government and Health and Education Sectors.*** Since budget control, accounting, and cash management for service delivery in central government is decentralized to 190 independent agencies, only a sample of these in two sectors could be addressed within the time and resources budgeted for the CFAA. The assessment examined the flow of funds and systems of a sample of agencies under the Ministries of Education and Health as representative of central government service delivery operations.

1.12. The education and health sectors were chosen, in part, because of the significance of their combined spending. Transfers to these sectors come to 31 percent of tax receipts, and the combined uses are over 25 percent of all national government uses (financed by tax receipts, fees and other sources). Additionally, the complex and transaction-intensive nature of operations warranted their selection.

1.13. ***External Audit.*** The Supreme Audit Institution in Chile (CGR) performs an ex-ante review on selected transactions and prepares the financial statements on the central government, but issues no opinion on the annual financial statements. The CFAA studied this arrangement to determine its impact on the auditor's independence.

#### **WORLD BANK'S INVOLVEMENT IN CHILE**

1.14. The WB Country Assistance Strategy (CAS) 2002 sets out three broad goals to support Government's programs: (1) sustain economic growth and social policy; (2) increase inclusion, especially of rural populations and vulnerable groups; and (3) modernize the state as the underpinning for the two previous objectives. Public financial management is central to public sector management which in turn is the main component of modernization of the state.

1.15. The WB's active portfolio consists of eight investment projects with a total value of US\$308.8 million, of which \$US138 million were undisbursed as of July 2004. All projects are rated satisfactory and, in particular, financial management in all projects is satisfactory.

1.16. One active WB investment project is the Public Expenditure Management Project, effective in 2002, which supports the development of an integrated financial management system for the central government and a centralized human resource management system. This operation supports directly the state modernization program of the Government.

1.17. The proposed lending program for FY02-06 to support the CAS 2002 would be approximately US\$500 to US\$650 million. The first part would consist of up to six investment loans, roughly one each year, for a total of about US\$250 to US\$300 million. The second part of the Bank's program would consist of one or two adjustment operations. The composition of the future lending program implies greater reliance on country financial management systems. While

systems contained in specific agencies involved with earlier projects have been assessed as part of project work, central systems have not previously been assessed.

#### **IDB'S INVOLVEMENT IN CHILE**

1.18. In accordance with the Government's program and the IDB's institutional strategy, the IDB's activities in Chile concentrate on three priorities: (i) support for initiatives that increase competitiveness and productivity; (ii) support for efforts to reduce social and regional inequalities and to improve living standards, with particular attention to vulnerable groups; and (iii) support for processes conducive to improving public sector management in the provision of public services, strengthening partnerships between civil society, the public and private sectors, and increasing citizen participation.

1.19. IDB's portfolio as of December 2003 includes 11 projects with a value of \$US 733.2 million. An additional six projects valued at \$US 263 million are in the pipeline. All projects are rated satisfactory and, in particular, financial management in all projects is satisfactory. Additionally, as with the WB projects, all project audited financial statements have been received by the due date of April 30 and were audited by the CGR.

1.20. IDB's active portfolio includes a \$15 million loan for the Modernization of the CGR, aimed at improving its management systems and enhancing its efficiency and operational effectiveness. This project constitutes a key linkage with the WB Bank's Public Expenditure Management Project.

## 2. CFAA ANALYSIS AND MAJOR ISSUES

### INSTITUTIONAL AND LEGAL FRAMEWORK

#### Overview

2.1. The legal framework for public financial management rests first, on a clear definition of roles between the legislature, the executive, and the autonomous external audit institution (CGR). Furthermore, the responsibility for planning, controlling and reporting of funds is set out in the law; responsibilities for treasury, budgeting and accounting are assigned to specific central authorities (Treasury, National Budget Office and the CGR, respectively).

2.2. Compliance with the legal framework on public financial management is encouraged in Chile by the active a priori oversight provided by the CGR and intervention by the other central authorities – DIPRES, National Civil Service Commission, Council for General Government Internal Auditing (CAIGG). Compliance with this framework is also encouraged through laws on probity and which provide that civil servants must act with transparency and reveal the procedures, contents and bases for decisions taken, and that they will be subject to administrative responsibility for their acts in addition to civil and criminal responsibility.

2.3. Compliance with the legal framework is evident from the timely financial reporting by the agencies and central authorities. Moreover, the strong control framework is a contributing factor to the low level of corruption perceived in Chile.

#### Organization of the Public Sector

2.4. Chile is a unitary state, with three independent powers: the executive branch, the legislature, comprising the senate and the chamber of deputies; and the judiciary, comprising the Supreme Court, ordinary, special, superior and appeal courts.<sup>9</sup> As outlined in the Organic Constitutional Law of the Bases for State Administration (Law No. 18575), the President is responsible for the government and administration of the entities set out in the law.

2.5. The administration of the state comprises: the ministries, governorships, state organisms and service agencies, including the Supreme Audit Institution (CGR), Central Bank, the armed forces, the regional governments, the municipalities and the state enterprises created under law.

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<sup>9</sup> Article 3 of the Political Constitution of 1980

## Legal Framework on Public Financial Management

2.6. The constitution provides the general basis for the state administration.<sup>10</sup> It calls for an Organic Constitutional Law on the Administration of the State,<sup>11</sup> which should determine the organization of the public administration and rules on the civil service. The constitution calls for an independent review entity, the CGR, to review the legality of the administrative acts and to control the revenue and investment of treasury funds, municipal funds, and of other public entities, as well as to keep the accounts of the state. It also stipulates that public treasuries may not make any payment without decrees or resolutions by a competent authority which approves the use of funds. Payments are to be made only in line with a cash release program and after budget availability is certified.

2.7. The Framework Law on Financial Management of the State, LAFE, defines the system of financial administration of the state (budget, accounting and treasury) and sets out the coverage of the system.<sup>12</sup> The entities covered are all those included in the national budget, i.e. all central and decentralized entities: all ministries, the Congress and the judicial branches, the Auditor General, the service delivery organizations; regional governments; and the social security and health funds. The LAFE provides for common standards to be applied to the budgeting, accounting and treasury operations and for the whole system to be guided by a public sector planning system.

2.8. The LAFE establishes the principles of comprehensive budgeting and a central treasury account, while assigning responsibilities for financial administration, budget formulation and execution to DIPRES and oversight to the CGR. It also provides framework rules for reallocation of funds during the execution of the budget, along with others contained in the Annual Budget Law.

2.9. The Annual Budget law sets out other provisions governing budget execution and development such as the size and management of the budget contingency fund, permitted transfers between budget items and the permitted level of public sector debt, arising both from the budget and other transactions. As suggested in the IMF Fiscal ROSC<sup>13</sup>, in other countries the first two provisions might normally be included in an organic budget law rather than separately legislated each year<sup>14</sup>.

2.10. All state income and expenditure should be reflected in the budget and the use of tax income must be governed by the priorities set in the budget. The accounting system operates on a decentralized basis with records kept in the service agencies as determined by the CGR. Reporting on the whole of the public sector is the responsibility of the CGR.

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<sup>10</sup> Law 3464 - Decreto Ley 3464.

<sup>11</sup> The General Bases for the Administration of the State Law (Ley 18,575).

<sup>12</sup> Ley Orgánica de La Administración Financiera del Estado.

<sup>13</sup> Chile: Report on the Observance of Standards and Codes – Fiscal Transparency Module, IMF August 2003, page 67.

<sup>14</sup> According to information received from the Chilean Government in April 2005, the recent amendments to LAFE reinforce the legal framework of the budget system and the consistency with international practices

2.11. The LAFE does not cover the autonomous universities nor the state enterprises, which operate under their own statutes, , but they are required to report yearly to the CGR on their financial position and the execution of their budgets.

2.12. State-owned enterprises (SOEs) comprise entities which operate under the Companies Act ( joint stock companies) and those entities created by separate legislation. Law 18196 provides the financial management framework for SOEs.

### **Public Financial Management Staffing**

2.13. Reforms on hiring and promoting public servants were introduced in 2003 to establish mandatory open competition for appointment and promotions in the civil service for the positions of director generals in the 100 non-policy-setting agencies, and for staff in all 190 agencies. To strengthen overall personnel management, a new personnel management directorate ( National Civil Service Commission) has been created in MOF, at the same level as DIPRES, to provide oversight of personnel policies and recruitment in the central government and regional governments for all entities which operate under the public service law for both contract and permanent positions. The Central Bank, Banco del Estado, the armed forces, the CGR and the state enterprises operate under their own framework laws.<sup>15</sup>

2.14. For management and staff positions in financial management, both selection and promotions are competitive with positions being advertised; the processes are carried out by authorized external professional recruiting and personnel consulting firms and overseen by an independent panel. Furthermore, the Ministry of Finance, in cooperation with the CGR, is developing and implementing a new integrated financial management system (SIGFE), and as a key element of the agreement with the agencies on its implementation, staff in the financial management areas must undergo training.

2.15. Ethical behavior in the public service is encouraged by the General Bases for the Administration of the State Law (Law 18575) which was amended to incorporate the following provisions on probity by civil servants:<sup>16</sup>

- that public officials must observe the principle of probity and must act with transparency and reveal the procedures, contents and bases for decisions taken;
- that personnel of the state administration will be subject to administrative responsibility for their acts, in addition to civil and criminal responsibility;
- that administrative acts of state administration and the related documents are public.

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<sup>15</sup> Law 19882 of June 17, 2003.

<sup>16</sup> Law 19563 of 1999.

## BUDGET DEVELOPMENT ISSUES

### Overview

2.16. Chile has a well-developed budget system which provides for a realistic and comprehensive budget, developed and implemented according to a well-defined timetable and processes. Performance issues are well integrated into the budget process and there is a partially developed medium-term fiscal framework. There is also a high level of budget transparency.<sup>17</sup>

2.17. Chile also has a long history of fiscal prudence. Current fiscal policy (a political commitment of the Government, rather than a legal requirement<sup>18</sup>) provides for a *structural* (i.e. underlying, or excluding the impact of short-term fluctuations output fluctuations and deviations of the copper price from its long-run estimated mean) budget surplus of one percent of GDP. Necessary adjustments to achieve this target are made to budget expenditures during the year. The budget process is dominated by the Executive since there constitutional restrictions on the role of Congress in the budget development

### Institutional Arrangements for the Budget

2.18. The budget development process is highly dominated by the Executive Branch of government. Under Article 62 of the Constitution, only the President may initiate revenue and expenditure proposals, through the Annual Budget Law. Congress may not increase any revenue or expenditure items in the draft budget; it may only reduce expenditures, and only those not governed by a permanent appropriation, such as debt services. If the draft budget is not passed by Congress within 60 days of receipt from the President, it becomes automatically adopted.

2.19. Furthermore, Congress may not scrutinize equipment purchases by the armed forces. The President's budget proposal is referred to the Budget Committee, which consists of 26 members, drawn equally from the Senate and the Chamber of Deputies.

2.20. Congress appears to make little systematic use of the performance information which is presented along with the annual budget proposal. However it appears to take greater interest in each agency's annual Comprehensive Management Report, which contains both financial and performance information (see discussion under Financial Reporting and Transparency). Congressional approval is required for SOE borrowing involving a government guarantee.

2.21. The strong role of the Executive Branch is also reflected in the powerful role of the Budget office (DIPRES), located within the MOF. Although reporting to and working

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<sup>17</sup> This section of the report has made extensive use of factual information contained in two earlier reports: Chile: Report on the Observance of Standards and Codes – Fiscal Transparency Module, IMF, August 2003, and an OECD report, Budgeting In Chile (2004). The assistance provided by these reports is hereby acknowledged.

<sup>18</sup> According to information received from the Chilean Government in April 2005, the recent amendments of LAFE reinforce the legal framework of the budget system

closely with the Minister of Finance, the Budget Director is appointed by and answers directly to the President. The budget process operates in a relatively “top down” manner and budget proposals developed by DIPRES are generally adopted with little or no change.

2.22. The Ministry of Planning (MIDEPLAN) also has a role in the budget process: to evaluate capital expenditure or infrastructure projects, and advise on their prioritization in terms of stated government policies. In doing this, it uses established cost-benefit analysis methodology. It also maintains a “project bank” of approved-in-principle projects, as discussed in the budget execution section of this report. It also advises on the ranking of new expenditure proposals submitted for the use of the “bidding fund” or Fondo Común Concursable (FCC).<sup>34</sup> MIDEPLAN also carries out systematic household surveys that feed into assessments of the impact of government policies and programs.

2.23. The Office of the Presidency reviews the President’s message to Congress on policy priorities that is issued in May each year before the annual budget circular is issued. It also reviews the draft budget before it is presented to Congress in terms of the President’s stated priorities. In consultation with DIPRES it also has bilateral discussions with ministers to discuss the President’s priorities for the budget.

2.24. Within each of the 19 ministries, budget and financial management issues are handled by a directorate of planning and budget, thus facilitating the integration of departmental planning and budgeting. Ministries coordinate the budget proposals of the various service delivery units or *servicios* under them. DIPRES conducts budget discussions with ministries rather than individually with *servicios*.

### **Budget Comprehensiveness**

2.25. LAFE establishes the principle of a unified budget. The budget covers all ministries and autonomous agencies, whose expenditures are appropriated on a gross basis, i.e., irrespective of receipts. The Copper Stabilization Fund and the Petroleum Fund also operate within the budget. (Also see discussion in Annex 2 under Budget Development.)

2.26. Reflecting the requirement for a unified budget, recurrent and capital expenditures are fully integrated in the budget process; there is no separate capital or investment budget. Likewise, all external funding from international institutions (such as WB and IDB) is fully integrated into the budget.

2.27. Staff budgeting is also fully integrated with financial budgeting<sup>19</sup>. Although there is no civil service ministry or equivalent, CGR maintains a register of all approved public service positions and approves all appointments and other changes. Thus each ministry and agency has a well-documented, authorized establishments structure covering both permanent (*planta*) and contract (*contratada*) staff, which forms an important part of the

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<sup>19</sup> Personnel costs account for about 17 percent of total expenditures in the 2004 budget.

base for budget construction. Authorized staff ceilings, which are part of the budget documentation, cover both types of appointment.

2.28. The small number of exceptions to the comprehensive nature of the budget are:

- Universities and research institutes, which are national government bodies;
- A transfer of 10 percent of the gross revenues of the national copper company, CODELCO, to the ministry of defense for allocation to the three services for equipment purchases, which is provided for in the reserved copper law.<sup>20</sup> This arrangement is an exception to the general prohibition on earmarking of revenues contained in the constitution. Aggregate information on this expenditure is contained in the public finance statistics and the quarterly budget execution reports. (See discussion in Annex 2, Reporting of Military Expenditure.)
- The armed forces may borrow for equipment purchases, although MOF may limit this to amounts consistent with expected future transfers from copper revenues. Such borrowings are not publicly disclosed.
- Significant quasi-fiscal activity is undertaken by the state-owned commercial bank, Banco Del Estado, which has the exclusive right to hold public funds, although there is no reliable estimate of the amount of this activity. The bank does not pay interest on the balances in the estimated 5,000 to 6,000 ministry and agency bank accounts (with average daily balances of between US\$500 million and \$800 million), but in return provides government banking services at no charge and social services such as maintaining unprofitable branches in rural areas and providing particular services for poor people. There are proposals for a general policy to remove such subsidized transactions and to have the costs of such services funded from the budget, by developing a transparent and commercial banking relationship between the Government and Banco Del Estado. (See discussion in Annex 2, Cash Management.)

### **Budget Process and Timetable**

2.29. Budget formulation proceeds according to a well organized timetable governed both by LAFE and the budget instructions issued annually by DIPRES. (See Annex 2, Budget Timetable).

2.30. The first phase of the budget process involves updating baseline expenditures for ongoing programs and other commitments. This is done by examining the

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<sup>20</sup> CODELCO's total export revenue for 2003 came to \$ USD 3.8 billion.

implementation of the previous year's budget and costing new programs which have previously been agreed for introduction in the current year. An across-the-board "efficiency dividend" is also deducted from most programs or items. DIPRES uses a web-based budget preparation module (SIAP) which will in due course be replaced by the new SIGFE system. ( See SIGFE under Budget Implementation)

2.31. The second phase involves bidding for funding of new policy proposals. In 2001 the concept of a "bidding fund" (*Fondo Común Concursable* or FCC), which is the difference between "committed" expenditures and available funds consistent with meeting the structural surplus fiscal target, was introduced. This enables ministries to put forward new policy bids, which are considered in conjunction with bids from other ministries. Proposals compete against each other in terms of their assessed effectiveness and consistency with government priorities, making use of performance information insofar as possible.

2.32. The perceived need for a mechanism such as the bidding fund reflects the fact that the Chilean budget system is relatively "top down" and incremental, with little change being made to the levels of committed expenditure for each ministry, which are set out by DIPRES in the budget circular issued in June each year. Ministries therefore do not play a very proactive role in the budget process. DIPRES proposals normally receive strong support from the Minister of Finance and the President. Although Ministers are able to propose reallocations of funds within the overall amount allocated to their ministry, it appears that this seldom occurs. This relatively predictable budget process appears to reflect the fact that government policies are relatively stable, are well articulated, and are well understood throughout ministries.

2.33. The budget and budget documentation are not required to include contingent liabilities, tax expenditures, or quasi-fiscal activities. However considerable information is now provided on these outside the budget process and documents, through separate reports to Congress by DIPRES. (See Annex 2, Contingent Liabilities and Tax Expenditures.)

### **Budget Allocations**

2.34. The budget is developed according to administrative categories for 190 *servicios* or spending units grouped into 19 ministries, of which 16 are "sector" ministries. The basic budget entity is the service agency. Each agency receives a block allocation for personnel expenditures and a block allocation for other operating expenditures, which provides for a significant degree of managerial flexibility. These items are part of several expenditure "sub-titles" or object groupings, others including transfers and capital expenditures. However separate budget limits are imposed on some inputs, such as overtime, travel, training and consultants. Staff ceiling controls operate in addition to the personnel expenditures appropriation. There are also limits on the number of vehicles each ministry may have. In addition, capital expenditure appropriations may be broken down into projects. There is no functional classification in the budget documents.

2.35. There does not appear to be an overall system of appropriation to programs ( that is a group of activities related to a specific objective). Rather some spending units may be designated as programs. Within each of the 19 ministries or *partidas*, appropriations are broken down into:

- *capítulos* (spending units) of which there are 190 in total, in effect agencies or *servicios*. There are 42 within ministries as well as 14 regional governments, which are part of national government.
- *programas* (107 in total) which are attached to a *partida*.

2.36. Some of these *programas* are equivalent to programs. Other programs are covered by individual line items. Therefore at present programs are not consistently a budget classification, nor are programs broken down by various inputs. However, beginning with the 2005 budget, it is intended to expand the program classification approach, with details of program inputs also being provided, with the aim of applying this approach to the entire budget in the mid-term.

2.37. *Gastos Reservados* are “reserved spending” lines in some ministries (Presidency and security related ministries), also referred to as “non-accountable expenditures” which are reported on only globally. However they amount to less than 0.1 percent of total spending. Such expenditures are subject to legal limits on their amount and purposes, and agency heads are required to certify that all expenditures under these items are for appropriate purposes. CGR also may review the legitimacy of these expenditures.

2.38. The budget allocations are maximum amounts that can be spent, and are permissive, not mandatory. The rules on budget flexibility given the service agencies are set out in the annual budget law<sup>21</sup> every year and included in the budget instructions<sup>22</sup> but must fall within the provisions of Article 26 of the LAFE. Budget transfers between ministries and increases in the budget totals must be implemented by a new law, while the MOF and the executing ministries may approve transfers among the group level of objects of expenditure. Considerable flexibility is granted to the ministries for allocation among the service agencies and to the service agencies in allocating resources within a subtitle of expenditure of an agency; this means that budget can be reassigned by the agency to the service delivery units and among items within a subtitle of expenditure (the exception is from programs which are items but appear in the budget law).

2.39. In principle the budget operates on an accruals basis. Under LAFE budgets are stated to be “estimates of the maximum amount for public disbursements and commitments”, with commitments being defined as accrued obligations. However in practice, the DIPRES budget information system SIAP records information on a payments basis and there is no formal system to measure and control commitments, so in practice within year budget control operates on a cash basis.

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<sup>21</sup> Law 19915 Article 4

<sup>22</sup> Decreto (H) No 1171 December 16, 2003

2.40. Moves to an accruals basis in the budget are further reinforced by an agreement between DIPRES and the IMF to move to the accruals based GFSM 2001 for fiscal reporting. This move will take place gradually and pragmatically. In the first instance a new government operations balance sheet is being developed, requiring reclassification of budgetary revenue and expenditure information. The second stage will include application of this basis to the 2005 budget and the implementation of systems for recording and controlling obligations as part of SIGFE. This will also lead to the development of a capital or asset usage charge, as part of ministry budget appropriations.

2.41. The aggregate financial statements prepared by CGR are also on an (full) accrual basis, and incorporate an aggregate balance sheet or “patrimonial statement”, (see discussion on Financial Reporting and Transparency).

2.42. A budget contingency reserve, which is governed by each annual budget law, is created to fund costs included in laws which may be enacted by Congress after the approval of the budget and other contingencies. For example Congress approves salary increases for government employees in special legislation in late December each year. The use of the contingency reserve is reported on in the budget execution reports prepared by DIPRES and in the Government’s annual financial statement prepared by CGR, since the contingency line item is a current transfer to other public entities in the Public Treasury budget. The specific spending agencies which receive the transfers report the uses under the corresponding program and object of expenditure.

### **Budget Documents (Annual Budget Law)**

2.43. The budget documents provide information for the main fiscal aggregates for the previous four years and the following three years beyond the budget year. The Law is limited to financial information. There is no discussion of programs or activities and relevant performance measures. Indicators are documented in the forms supplied for preparation of the budget and presented as an integral part of the submission of each agency. The indicators are sent formally to Congress with the budget submission and reviewed along with the appropriation proposal.

2.44. Accompanying the annual budget law is the Report on Public Finances presented by the Budget Director, which is also available in English on the DIPRES external website, [http://www.dipres.cl/fr\\_news\\_english.html](http://www.dipres.cl/fr_news_english.html). This report includes discussion of macroeconomic conditions and projections of major fiscal aggregates three years beyond the budget year. There are also discussions of topical issues (which may change between years), such as a discussion of accrual accounting and budgeting in the 2004 budget report.

2.45. Also accompanying the annual budget law are the Instructions for the Execution of the Annual Budget Law, including an Annual Compendium of Regulations on Public Sector Financial Management, so that all applicable rules are available in one comprehensive document.

## Performance Information in the Budgetary Process

2.46. Chile makes extensive use of performance information in the budget process.<sup>23</sup> This occurs through two main mechanisms, managed through a separate unit of DIPRES

- (1) a system of performance indicators developed for ministries and agencies, and
- (2) a system of program evaluations.

In addition the “bidding fund”, discussed above, makes extensive use of performance information.

2.47. Reflecting the relatively top-down nature of the Chilean budget process, it is DIPRES which develops proposed performance indicators for agencies and programs, although these are discussed and confirmed with agencies. For the 2004 budget process, over 1,600 performance indicators had been developed for 132 of the 190 agencies. These indicators cover issues of effectiveness, efficiency, economy and service quality. DIPRES reviews these indicators and target levels of performance in terms of their general consistency with budget appropriations. However no direct or mechanistic link with budget appropriations is attempted. The indicators are reported to Congress in budget documentation as annexes to the budget submission for service. They are also reported in the Comprehensive Management Report which is submitted to Congress by each ministry or agency at the end of the year.

2.48. In the case of education and health expenditures, budget construction is mainly output focused, reflecting the basis of funding. For example in education much of the expenditures represents transfers for individual schools, which are funded on the basis of unit costs for average number of pupils attending. (These unit costs are tied to movements in civil service salaries.) In health the funding of service providers is based on unit costs of service, using a case mix approach which aggregates and weighs different health services provided to individuals. (See Annex 2, Budget Implementation - Health and Education.)

2.49. A formalized system of program evaluation was established in 1997, and so far over 150 major evaluations have been carried out. The principles governing evaluations are that they must be public, independent, reliable, relevant, timely and efficient. DIPRES agrees with Congress on the programs to be evaluated and manages the evaluation process. Each evaluation is undertaken by a team of three external consultants from varied backgrounds, which is seen as ensuring that the evaluation is fully objective. However the relevant agency is consulted throughout the evaluation and has a counterpart team to work with the evaluators. A logical framework approach has been used in the past, but there is now a move to impact assessments to provide a greater focus on final results. Each evaluation report is delivered within four to nine months and then sent to

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<sup>23</sup> A detailed discussion of this topic is contained in *Systems of Management Control and Results-Based Budgeting, The Chilean Experience*, Government of Chile, National Budget Office January, 2003.

Congress; the reports are also published on the DIPRES website and are publicly available.

2.50. Such evaluations have impacted on the budget in a variety of ways. In some cases they have confirmed the effectiveness of existing programs. In others they have led to major program redesign.

### **Medium Term Fiscal Framework**

2.51. The budget documentation includes medium-term targets for the structural balance and medium-term projects (four years out) of the main fiscal aggregates, prepared by DIPRES. This information is updated twice yearly by DIPRES. However there is no reconciliation or explanation of the changes in these aggregates from year to year, or as each year is rolled over. In addition the projections are only in aggregate form and do not include details of the spending programs, although it appears that DIPRES maintains information on these.

2.52. However this information is currently used only by DIPRES, in developing the annual budget scenario (for example, whether or how much funds might be available for a “bidding fund”) and possible expenditure reallocations. Ministries are not provided with these out-year figures. The projections are not therefore used to provide medium-term indicative funding levels (or changes therein) to spending ministries, as would occur under a fully operational MTEF. Given that this information already exists within DIPRES, it would be a relatively small step to initiate such an approach, which would enable a more active use of medium-term information in the resource allocation process.

### **State Owned Enterprises**

2.53. Non-financial SOEs are important in the mining and oil sectors. Turnover in 2003 of just the three largest (CODELCO, The National Petrolian Company ENAP, and the National Mining Company ENAMI) exceeded US\$ 6 billion. There are some 30 SOEs in total, including 14 partly privatized water utilities. They are divided into two main groups:

(1) those which operate as joint stock companies, and are owned by CORFO, which is established by a separate framework law, to operate as a holding fund for recording the state investment in and flow of funds to and from these entities. CORFO operates as a department within the Ministry of Economy, Development and Reconstruction.

(2) another 13 SOEs (covering the state petroleum and mining companies, postal service, National Television, State Railway Company and 10 port authorities), which are established under their own legislation. In all cases they are required to have a board of directors and prepare annual audited financial statements. The cash flow to and from these state enterprises appear as income and uses directly in the Public Treasury budget.

2.54. Under the Production Development Corporation or CORFO, the Committee for System of Public Enterprises (SEP) has oversight of all public enterprises and provides for MOF financial overview, including a requirement that their annual (cash-based) budgets must be approved by an MOF decree and their budget execution reports must follow GFS classification.<sup>24</sup> SEP entities include the Santiago Metro (which receives financial support from the Budget) and the water entities. The state copper company CODELCO, the armed forces enterprises, and Banco del Estado operate under separate arrangements as discussed under Financial Reporting and Transparency.

2.55. SOEs pay income tax on their profits (at the standard rate of 17.5 percent) and in addition pay a “surcharge” equivalent to 40 percent of these taxes into the budget, which is in effect a dividend payment. Quasi-fiscal (social) activities are carried out by some SOEs, for which they receive payments direct from the budget. CODELCO, however, pays all its profits to the Budget, with its capital expenditures being financed through funds retained through the depreciation charge.<sup>25</sup> Any borrowing by SOEs requires MOF approval through a decree, and if it involves a government guarantee this must be approved by Congress through a law.

2.56. All these entities operate under a cash budget approved by the Ministry of Finance and the corresponding sector ministry and publish their annual financial statements with an audit report (with the exception of the military enterprises). The 2004 Budget Law adds the following reporting requirements for these entities. “DIPRES will present to Finance Committee of the Senate and the Congress and the to the Special Budget Commission the following:

- Quarterly balance sheet and income statement by company and for each company and in aggregate will be prepared by the SEP within 15 days of the due date of such reports to the Securities Exchange Commission (SVS).
- Annual balance sheets and semi annual financial statements of public enterprises, prepared in line with the requirements for listed companies, as well as of the National Television Corporation, CODALCO and the Banco del Estado within 15 days of the due date to the SVS.”

2.57. There is also consolidated financial reporting on SOEs in two reports: (1) the GFS based public finance statistics prepared by DIPRES (excluding the military enterprises) and (2) the annual aggregate financial statement prepared by CGR (excluding CODELCO). (See Annual Financial Report under External Financial Reporting and Transparency.)

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<sup>24</sup> SEP operates as a committee of CORFO. It has a government-appointed council of nine members. It is responsible for selecting SOE directors, approving SOE strategic plans and draft budgets, and monitoring overall performance.

<sup>25</sup> CODELCO’s contribution to the income in the 2004 Budget comprises dividend income and income taxes receipts; it was estimated at 496 billion pesos for 2004 (Annex 4, Table I.2.2).

## **The Budget and Sub-national Governments**

2.58. Chile has 241 municipalities whose expenditures accounted in 2003 for some 1.5 trillion pesos or 13 percent of national government expenditures. Regional governments form part of the Ministry of the Interior's budget and their expenditures comprise primarily investments

2.59. Municipalities share responsibility with national government for basic education and primary health care. Transfers represent 10 percent of their income from central and regional governments, largely reflecting the number of students or patients, with some top-up of financing from municipalities' own revenues, which are taxes (on vehicles, business licenses, and a share of the territorial tax), user fees, and transfers. They are not permitted to borrow, although according to the IMF Fiscal ROSC, there are apparently cases of expenditure arrears or ad hoc financing. The Municipalities Common Fund, held in the National Treasury, is a pool of municipal property taxes for redistribution to poorer municipalities, provided they meet certain financial management standards. (Also see Annex 2, Reporting by Municipalities.)

## **BUDGET IMPLEMENTATION**

### **Overview**

2.60. Budget implementation is supported by predictable funding, achieved through effective cash allotting and tight budget monitoring, which at present depends on the separate budget and accounting systems in the service agencies but is closely overseen by central authorities through the *ex-ante* review in the CGR and the regular reporting to DIPRES and CGR.

2.61. An integrated financial management system (SIGFE) is under implementation to replace both the stand alone systems in the service agencies and the central systems of DIPRESP and CGR. Not all the arrangements are in place for the implementation of SIGFE centrally.

2.62. The health and education sectors employ a system of budgeting and monitoring of outputs that has provided a method of planning and funding the most important expenditures of the budget (education subsidy and pre-priced services in hospitals) with excellent predictability, since both the rate and volume are reliably estimated. At the same time, demand volumes reported by the providers and compliance with the standards of quality of the service are closely and effectively monitored.

### **Monitoring of Budget Implementation**

2.63. Two stages of expenditure are recognized in the reporting on budget execution: accrued and paid. The budget is the limit on accrued expenditures and on the payment so the reports prepared by the service agencies cover the two stages. The earlier commitment stage, however, is not recorded in the budget controls or reported.

2.64. While budget development rests mainly with the executive, and within the executive is centralized in the Budget Directorate of the Ministry of Finance (DIPRES), budget execution and accounting, on the other hand, is highly decentralized. Budget control and accounting of the central government depend entirely on the records of the service agencies, from which periodic reports are generated and sent to central authorities (DIPRES and CGR) for monitoring and aggregation. Service agencies have authority to sign contracts (subject to CGR ex-ante approval), exercise control over their assets and cash, hire staff (subject to CGR ex-ante approval), and reallocate funds within their institutional budget, respecting the block allotments to personnel and other operating expenditures and taking into account the annual rules on budget uses for specific items.

2.65. Expenditure monitoring rests on:

- four cross-cutting oversight mechanisms by central authorities (ex-ante review by CGR, personnel cost controls, investment controls (see Institution Arrangements for the Budget), and cash allotments;
- the individual financial management systems in the individual service agencies;
- two centralized monitoring systems (SICOGEN in CGR and SIAP in DIPRES).

#### Ex -ante Review by CGR

2.66. The CGR in general is charged with ensuring the legality of all administrative acts; additionally, it is charged with the prior review of all ministerial resolutions for their legality. Under its own Framework Law, the CGR is required to keep a registry of all laws set by the Executive, approve all decrees and resolutions on budget or resource uses, and prepare opinions on budget transfers and supplements. It is also required to keep a Registry of Public Servants (permanent and contracted) and the related decrees and resolutions which authorize these.

2.67. Given the decentralization of the execution of the budget to the 190 service agencies the CGR has taken two steps to enable it to discharge its duty: (i) it requires that all personnel contracts be sent to the CGR for recording in the personnel registry. and (ii) it has extended the review of legality (*toma de razon*) beyond the review of laws to the review of the contracts involving the use of funds. The instructions on the annual budget contain an instruction from the CGR on of the threshold defining which contracts will be subject to prior review by the CGR.

2.68. On the prior review of contracts, the time required at present is predictable and taken into account by the executing agencies. There is potential for reducing this delay under the centralized databases of the new integrated financial management system (SIGFE), since the CGR's access will allow automation of a greater portion of the review. This step in the contract processing would be eliminated if the CGR moved from an ex-ante review basis to an ex-post review.

### Personnel Costs

2.69. Salary costs represent 17 percent of the national government budget. Chile's public service comprise permanent staff with tenure, who operate under the public service labor law (the CGR, Central Bank and military have separate legislation); contract employees who operate under 12-month contracts with no tenure, and consultants who are paid on a fee-for-services basis.

2.70. While budget execution is decentralized to the 190 agencies, including the responsibility for payroll preparation, recording and payment, there are extensive, centralized controls applied to personnel. Controls over personnel comprise first, the specific budget appropriation, and second, the cash allotments for personnel costs by DIPRES separate from the rest of the budget. Also the number and the positions which may be filled are stated in the budget text for each Service Agency.

2.71. As the CGR is charged with keeping a personnel registry, it has established rules to be followed in notifying it of all hiring by all agencies. It is on this basis that the CGR can certify the compliance with the personnel limits of the budget. To support this, a new government staffing information and control system (SIAPER) is being jointly developed by DIPRES and CGR. The principle objective is to support CGR in approving and controlling staff recruitment. This new automated system would facilitate CGR giving up its ex-ante role and replacing it by ex-post review; it could also be used to feed a payroll module of the new integrated financial management system.

### Cash Allotment

2.72. At the time of the approval of the budget, the annual cash outlay program is also set by DIPRES in conjunction with each agency. This cash program is reviewed and updated if necessary by the DIPRES on the 25<sup>th</sup> of the preceding month. On the basis of an annual cash program, updated monthly, DIPRES instructs Treasury to effect the transfers twice a month to the current accounts of the service agencies to cover their operating requirements. The allotments are separated into amounts for personnel and other expenditures and are paid to the agencies in mid-month and end of month tranches.

2.73. The monthly cash ceilings are set with the Ministry of Finance without consultation with the spending agencies; however, given the good rate of budget funding (96 percent in 2003) and the flexibility that agencies have for deciding on the uses of the allotted funds, the centralization of setting the cash ceiling is not seen as interfering with program execution. While there is no authority for short term indebtedness, to support the execution in line with approved cash programs, the Finance Dept of DIPRES may sell a portion of its short securities issued by other state entities and repurchase these before year end.

2.74. Once funds are transferred as cash allotments, they are under the control of the service agencies, or the second-tier entities under the agencies, and are not under any direct or indirect control of the Treasury Department. These funds are deposited in non-interest bearing accounts in the Central Bank and the Banco del Estado. Although there

are 190 agencies, there are also bank accounts in entities which operate under the services (hospitals for example); the number of active current accounts in the central government is close to 5000. Neither the Treasury nor the Finance Department of the Ministry of Finance has access to the banking information and must depend on the monthly financial reports to determine cash balances. The determination of actual balances in the bank accounts is not reported and generally not available to the central authorities. The central authorities estimate the book cash balances once a year, in October, from the initial balance and the actual transfers less actual expenditures reported in the monthly budget execution reports. It is estimated that the idle balances fluctuate between US\$500 and 800 million. ( See Cash Management in Annex 2.)

### Controls in the Agencies

2.75. In the Chilean public sector each service agency, and operating entities under agencies, have freedom in selecting financial management systems but are governed by the central authorities' reporting requirements for monthly and annual reporting on the budget execution. These systems themselves are rigid (in that transactions are not reported to agency headquarters but only reports on net movement by account), inadequately integrated, and can provide information only in hard copy or in text files to the central authorities (DIPRES and CGR). Information from these individual stand alone systems is provided in different formats, and transaction and maintenance costs are high given the various software and hardware systems and need for multiple data entry. These systems do not provide adequate control over the budget commitment process and contribute to the diffusion of government bank accounts, which are costly to administer and undermine effective cash management. Furthermore, the dispersion of the central government's financial transaction processing in these multiple systems makes it impossible to link the data to other information systems covering public investment, procurement, and human resources. DIPRES and CGR authorities are particularly concerned about the lack of appropriate controls and information on agencies' outstanding commitments and accounts payable.

### Central Monitoring Systems

2.76. All service agencies (as well as the municipalities) report monthly to the CGR and DIPRES on the budget execution and provide their patrimonial accounts in standard formats according to the approved budget classification and the government accounting codes; the universities and SOE's report only semi-annually.<sup>26</sup> To support DIPRES in its budget monitoring an automated budget control system (Sistema de Información de Administración Presupuestaria del Sector Público or SIAP) was developed comprising modules on budget preparation, budget execution, and financial planning. This system is cash based and is used to record all budget updates and the cash program and its

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<sup>26</sup> The CGR established the reporting requirements, along with the basis for recording and reporting in the Regulations of the Nation's Accounting System (Oficio CGR No. 6,856 de 1992), and these requirements are obligatory for all public entities.

execution. Information is entered on the basis of the monthly budget execution reports provided by the service agencies. This provides DIPRES with information on the rate of budget execution and permits it to determine if payments are in accordance with budget authorization.

2.77. Reporting to CGR is done through its Accounting Division, which is responsible for budget control and the preparation of the financial reports, including reports on budget execution. To this end, CGR operates SICOGEN which provides budget control and updates the financial statements by recording net transactions by major financial statement classification as provided by the agencies. On the budget execution, the CGR system must first record all budget changes against which the actual is recorded. This system is accrual based and it enables the CGR to express an opinion on the budget changes requested by the service agencies. As discussed later, the development of the SIGFE will enable these two separate budget execution monitoring systems to be replaced by a single system.

2.78. The Treasury Department, on the other hand, keeps its own double entry accounting system as a separate accounting entity (it is a Service Agency) to record the movement in the single treasury account, the tax revenue and the related accounts payable and receivable, as well as its investment and financing operations. These records constitute the official books on the cash balances (*cuenta única fiscal*) of the Treasury, national debt and revenue. The bank balances are reconciled daily with the accounting records.

### **Financial Management Information Systems and SIGFE**

2.79. As noted, to address the concerns on poor central and decentralized financial management systems, an integrated financial management system, SIGFE, was developed and is under implementation. This system aims to both support the current decentralization of financial management to the service agencies and offer DIPRES and CGR the capacity to aggregate in one system both accounting and budget information generated from the individual service agencies, thereby allowing them to consolidate the entire budget information from a uniform and reliable base. A centralized personnel management system, SIAPER, was also developed. To optimize hardware investment and reduce maintenance cost, SIGFE will operate from a central data center (the operation of which may be outsourced) under the responsibility of either DIPRES or CGR.

2.80. SIGFE applies the new accounting and budget classifications which support the determination of fiscal reporting (GFS) on an accrual basis and therefore directly supports the Government's plans to move to accrual-based fiscal reporting. In the meantime, while fiscal statistics still report on cash, it applies conversions to generate the input for consolidation on the current cash accounting and budget reporting basis. At the aggregate level it is planned that SIGFE will provide for the aggregation and consolidation of the accounting balances and the budget execution of the agencies. Considering that not all agencies will implement SIGFE in order to provide government-wide information, while implementation is still underway, it is planned that agencies

which have not yet adapted SIGFE will submit accounting and budget information in a format compatible with SIGFE aggregation processes.

2.81. At the agency level, SIGFE integrates accounting, budget (including cash programming) and treasury operations. The budget control module provides for the recording and control of budget commitments. The system is similarly applied to independent service delivery units within an agency such as hospitals. It is geared primarily to satisfy central reporting requirements and as such does not displace the more specialized applications for administrative operations of purchasing, asset control, invoicing, personnel, payroll or even highly specific cost and management accounting requirements.

2.82. At present, SIGFE is limited to budget control, accounting and treasury modules and is not integrated with Chilecompras, the electronic portal for state procurement of goods and services. Chilecompras which is being revamped to include a full complement of disclosure facilities: procurement plans, invitations to bid, contract awards, database of past transactions and corresponding search and statistical functions, and a standard product/service coding catalog<sup>27</sup>.

2.83. On the strictly financial controls, SIGFE stops short of providing the critical integration with physical asset subsidiary ledgers (inventory and fixed assets). A comprehensive system would integrate both purchasing and the related movement in the physical asset controls. Also, although SIGFE's core applications are budget, accounting and treasury, there is no provision for an automated bank reconciliation, which should be developed in line with treasury and accounting<sup>28</sup>.

2.84. To date, 37 service agencies are operating with SIGFE; another 40 are running SIGFE in parallel to their own systems<sup>29</sup>. Implementation of SIGFE does not affect the decentralization of accounting which is provided for under the LAFE since the agencies will operate the system and retain the same authority and responsibility. One hundred service agencies will have implemented SIGFE by the end of 2004; by the end of 2005 full implementation is expected, at which time it is stated that the SICOGEN and SIAP systems will be discontinued. It is yet to be decided, however, what organization will be responsible for operation and maintenance of the system.

2.85. On the implementation at the center, the Constitution and the LAFE assign the CGR responsibility for the accounting of the nation; this does not imply, however, that it must operate the system which processes the transactions just as it does not operate these under the current decentralization. Under the current law, the CGR must satisfy itself that it can rely on the system where the transactions are processed so it can produce the accounts of the nation.

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<sup>27</sup> According to information received from the Chilean Government in April 2005, the development of the interface between SIGFE and the 'Banco Integrado de Proyectos' is on its final implementation stage

<sup>28</sup> According to information received from the Chilean Government in April 2005, the bid preparation for the procurement of the modules for bank reconciliation and fixed assets ledger is in its final stage

<sup>29</sup> Annex 4 of this document provides the status of the implementation of SIGFE as per the information provided by the Chilean Government in April 2005.

2.86. At the same time, DIPRES is responsible for regulating the budget, including the cash programming and the establishment of a financial and administrative information system to support the application of the LAFE. Given that SIGFE integrates both accounting and budget controls, the needs of CGR and DIPRES would be satisfied by the same system.

2.87. Risks that arise from a failure to implement SIGFE centrally as the sole financial administration system include: undermining the adoption of SIGFE in the decentralized agencies which will perceive a lack of commitment to the system; a lower return on the investment since duplicate systems costs will persist; and inconsistencies between separate systems underlying the reporting of aggregate budget information.

2.88. Benefits from having a uniform system operating both at the decentralized and central level, however, include ensuring, at the agency level, a common accounting basis for budget reporting (accrual) and control of commitments for enhanced cash planning and fiscal reporting, reduced maintenance cost and a uniform level of reliability in agencies. Associated with this uniform application would be the opportunity for externally financed projects to be administrated exclusively through the agencies' financial management systems and do away with redundant project financial management systems. This mainstreaming would imply reduced transactions costs of investment financing and improved reporting.

### **Recommendations on Budget Implementation**

2.89. Given the role of SIGFE in the aggregate budget control and financial reporting, the steps to cover the outputs of SICOGEN and SIAP and the arrangements for the operation of the centralized applications should be agreed upon well in advance of the 2005 deadline for full conversion to SIGFE. Steps toward this end would begin with settling which entity will operate the centralized SIGFE application; a sign-off that its provisions comply with the reporting needs of both the CGR and DIPRES and an explicit commitment to rely on SIGFE once implemented.

2.90. With the introduction of SIGFE, it is critical that the recording of the stages of budget uses be integrated with Chilecompras (government-wide and obligatory purchasing system) whereby the issuance of purchasing authorizations under Chilecompras would create the charge against budget availability.

2.91. Although the centralization of the databases under SIGFE would permit the integration with other centralized databases of suppliers, personnel, and public credit, the current design of the system does not provide for this integration.<sup>30</sup>

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<sup>30</sup> Procurement (*Chile Compras*), Debt Administration, Project Bank, and Personnel Management System (SIAPER)

## **EXTERNAL FINANCIAL REPORTING AND TRANSPARENCY**

### **Overview**

2.92. Chile has a high level of fiscal transparency. Reporting is timely and comprehensive, and much of it is publicly available on government websites. However, given the number of financial reports discussed below, it is also somewhat fragmented and duplicative, with both DIPRES and CGR playing major roles. There is room for improvement, both in the aggregate financial statement prepared by CGR and in reporting on the financial operations of the military.

### **Annual Budget Law**

2.93. The draft budget law provides comprehensive information covering the main fiscal aggregates for the four years prior to the budget and projections for the following three years. As discussed in the section on budget construction, the budget documents provide comprehensive coverage of the public sector, with the exception of universities and research institutions, military expenditures financed under the Reserved Copper Law, and the quasi-fiscal transactions of Banco del Estado.

### **Reporting on Budget Execution**

2.94. Reporting by DIPRES on budget execution is made formally to the Committees on Finance of the Senate and the Chamber of Deputies and is governed by Law 19915. This information is also available publicly on the DIPRES website. This reporting by DIPRES is cash based. DIPRES publishes a monthly operating statement on the central government's budget within 45 days after each month end. Starting in 2004, this statement will be accrual based and presents the budget uses in line with classification of the new IMF GFS 2001 manual, thereby permitting the generation of an operating result, the financing requirement or surplus, and the disclosure of the detail of the financing of the net borrowing requirement arising from central government's budget execution.

2.95. DIPRES also produces and publishes a more detailed quarterly budget execution report within 45 days after the end of each quarter. It comprises the same operating statement as in the monthly report but the quarterly report presents the results of budgeted activity in one column and adds another column with the non-budget activity. This innovation produces more comprehensive information and facilitates the reconciliation of the change in debt with the financial performance of the quarter. The report also includes information on the breakdown of taxation revenues, financing items and movements in gross government debt, and aggregate defense equipment expenditures under the Reserved Copper Law. Lastly, the quarterly report includes statement of budget execution (actual against original and modified budget) in the same detail as presented in the budget law, i.e. by service agency, major expenditure type, and expenditure item where these have been set out in the law.

2.96. An annual report on budget execution is also provided by DIPRES within 45 days after year-end, which is a summary of the quarterly reports. There is also a mid-year

report from DIPRES to Congress updating revenue and expenditure projections for the current year. This does not lead to any revision of the formal budget allocations, but it may affect the rate of actual budget execution.

2.97. CGR reporting on budget execution is accruals based, see Annual Financial Report on the Public Sector below. It is contained in the CGR Annual Financial Report, which is public, and in a quarterly report which is distributed to the Finance Commissions of the Senate and Congress, to the executive and the ministries.

### **Annual Report on Public Finances by the Budget Director**

2.98. As discussed in the budget construction section, this report accompanies the draft budget law presented to Congress. It was instituted in 2002 to enhance Congress's annual discussion of the Budget, by providing in-depth analysis of the macroeconomic framework, as well as other background information on a range of fiscal topics.<sup>31</sup> This report became permanent and mandatory through Law No. 19896 of September 2003. Apart from reviewing the macroeconomic scene and providing forecasts of the major fiscal aggregates, it provides a general analysis of fiscal risks and from 2004 onwards will provide more detailed information on financial assets and public debt, to expand that provided in the annual financial statement prepared by CGR, along with information on contingent liabilities and tax expenditures.

2.99. The report may also discuss topics of special or current interest. For example, the October 2003 report also discusses the methodology for the calculation of the budget structural balance, fiscal sustainability, moves to adopt the IMF's GFSM 2001 system for public finance statistics, and the level of rigidity in Chilean budget expenditures.

### **Public Finance Statistics**

2.100. Public finance statistics are presented by DIPRES in a Public Finances Yearbook published around April each year. The information is broken down into four levels: central government, municipalities, general government, and state-owned enterprises (non-financial public sector), with comparative information being provided for the previous nine years. The scope of general government is broadly consistent with the IMF's GFS 2001 Manual. MOF has agreed with IMF that it will move to adopt the accrual-based GFSM 2001. Since 2002 the publication includes the aggregate expenditure on defense equipment under the Reserved Copper Law.

### **Comprehensive Management Reports<sup>32</sup>**

2.101. Under LAFE, updated by MOF decree, agencies prepare comprehensive management reports, which review their objectives, management targets, and results. Their preparation is also governed by the instructions issued by DIPRES and guidelines available on the DIRPRES website, which is referred to in the instructions accompanying

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<sup>31</sup> Prior to this, there was a report accompanying the draft annual budget law, focusing only on macroeconomic issues.

<sup>32</sup> Known as BIG – Balance Integral de Gestion

the annual budget law. While the focus is on performance indicators, it also covers progress against the targets set by the annual management improvement plan (MIP) required for each ministry or agency, and progress in implementing the results of any evaluations carried out in that agency or ministry. This report also includes financial information prepared according to the annual instructions prepared by DIPRES.

### **Annual Financial Report on the Public Sector**

2.102. Responsibility for the preparation of the aggregate annual accounts on the public sector is assigned by the Constitution to the CGR.<sup>33</sup> The framework law of the CGR makes the Auditor General responsible for reporting to the President and to Congress by April 30 of each year on the budget, financial and equity situation of the State for the preceding fiscal year.<sup>34</sup> To this end, the Accounting Division of the CGR publishes an annual financial report which includes statements on budget execution and the financial position of the public sector. The report is provided to the President and to the Presidents of the Senate and the Chamber of Deputies. It is also distributed to the ministers and is posted on the website of the CGR (the 2003 report is now on the site).

2.103. The report comprises information on the entire non-financial public sector (Central Bank and Banco del Estado are not included) except for the national copper company, CODELCO. The report is issued within three months of the year-end. It contains information on the financial position on a full accrual basis (i.e. including fixed assets and a depreciation charge) and on budget execution on a modified accrual basis for the reporting year and the four preceding years. Information for the reporting year is presented by subtitle (object of expenditure) and by sector.

2.104. The statement is divided into four sections; the Public Sector, comprising all ministries and the service agencies of the central government; the Municipal Sector, comprising the municipalities and their service establishments; State-Owned Enterprises and the state's research institutes; and the public universities. For each grouping, the report includes: a comparative balance sheet, a non-comparative statement of cash flow, and statements on budget execution. A separate Statement of Budget Execution and Cash Flow Statement of the Treasury are presented in an annex to the report, which presents budget execution on a cash and on an accrual basis.

2.105. For each state-owned entity the report summarizes the financial result, assets, liabilities and net equity and where appropriate, budget execution. However the national copper company CODELCO and Banco del Estado are excluded from the CGR report. Furthermore, the state-owned enterprises statement does not include the CORFO-controlled entities, whose investment appears in the Public Sector section, so there is no comprehensive view on total assets, liabilities or results for that sector. These companies do report individually as joint stock public companies.

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<sup>33</sup> Article 87 of the Political Constitution of the Republic of Chile (Decreto Ley No 3464).

<sup>34</sup> Article 142 of Law No 10,336 (Framework law of the CGR).

2.106. The annual financial statements of the 16 public enterprises established in law (but not the military enterprises), which include the state petroleum and mining companies, Chile National Television and State Railway Company and 10 ports, are separately prepared on an accruals basis, using accounting standards applicable to the Chilean private sector, and are audited by private auditing firms. CGR has access to these companies' records in its work, except CODELCO, but does not duplicate the financial statement audits

2.107. There is no reporting by the three enterprises operated by the military beyond the summary information provided in the CGR Annual Financial Statement, and no external audit opinion prepared on their financial statements. (See Annex 2, Reporting on Military Expenditure.)

2.108. Overall this annual financial report is timely and comprehensive, and reliable in that it is generated in an environment of good internal control with regular ongoing external oversight by the CGR. The report facilitates analysis by sector, since it presents the financial position and budget execution of each sector separately, i.e. central government, municipal, state enterprises. It is a useful source of information on the state's equity and financial position; for example, on liabilities. Beginning in 2003, even the vested pension liability for past service under the former social security pension plan (Bonos de Reconocimiento), which is the most significant liability of the public sector,<sup>35</sup> appears in the general government sector balance sheet. However, this liability is offset by a corresponding asset, apparently on the basis that the liability is not payable in some cases for many years. The recognition of such an asset does not appear to be in accordance with generally accepted government accounting standards.

2.109. The statement could be improved, firstly, in terms of what would normally be expected for such aggregate statements:

- (i) there is no statement of accounting policies to provide the basis for recognition and valuation of investment, inventories and other assets. Nor is there any information on the basis of the consolidation within the four components, and
- (ii) there is no audit opinion, which is important in providing credibility to the statement;

and secondly, on more specific matters of content:

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<sup>35</sup> As of end December 2003, this liability is greater than the total patrimony stated in the consolidated balance sheet of the public sector. In the public finance statistics published by the Ministry of Finance, the entire debt is now recognized and the interest on the outstanding bonds is treated as an expenditure, while the paid maturities are treated as a financing operation (below the line).

- (iii) there is no operating statement to explain changes in net worth between years;<sup>36</sup>
- (iv) the National Copper Company, CODELCO, is excluded, meaning a significant under-reporting of the government's assets;
- (v) interest on debt is not recorded or reported on an accrual basis;
- (vi) contingent liabilities are not fully reported (see Annex 2, Accounting Standards and Contingent Liabilities);
- (vii) there is no consolidation of the all entities controlled by the central government into a single statement;
- (viii) the agency asset registers on which the patrimonial balance is prepared are known to be outdated and unreliable in many cases (see Annex 2, Asset Management) .

2.110. The statements offer information on budget execution on an accrual basis and the financial position of the service agencies that is not provided by DIRPES through its SIAP system. With the improvements suggested above, the report would be more useful to Congress as a mechanism for holding the executive accountable. It would be a short step for this key financial statement to achieve closer adherence to international accounting standards by addressing the deficiencies listed above.

### **Recommendation of External Reporting**

2.111. For Chile to emerge at the forefront of public sector management, it should issue its annual financial statements with an audit opinion and move to close adherence with internationally accounting standards in its reporting. Most significant is the lack of any external audit opinion on the government financial statements; this is not consistent with a modern approach to public sector external auditing. The aggregate statements (Annual Financial Report) themselves must be improved and the range of individual financial reports could be rationalized. Specifically, the financial statements must adopt a full set of notes, include an income statement, and include in its coverage the impact of its principal state enterprise, CODELCO.

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<sup>36</sup> The budget statement is the only information available to partly explain the change in net worth but is on a modified accrual basis, while the financial position is based on full accrual. It is understood that the Government is reluctant to present a financial result that is different from the one appearing in the budget statement.

## INTERNAL CONTROL AND INTERNAL AUDIT

### Overview

2.112. Chile is well advanced in the adoption of the modern concept of internal control as a management responsibility and as a basis for performance-based government. Since 1997 it has achieved positive results in internal control and audit, and is making progress—in some cases, substantial progress—in the use and assessment of internal controls. In accordance with the standards of the Institute for Internal Auditors, the Executive Branch has established an independent internal audit function as a key part of the internal control structure and established objectives for the this function. The Chilean government internal audit function has been organized around three separate but well coordinated units:(1) the Council for General Government Internal Auditing (CAIGG),(2) Ministerial internal auditors, and (3) internal audit units of individual service agencies or enterprises.

2.113. Presidential decrees and central overview of the internal audit function in ministries, agencies and public enterprises have assisted in the creation of a culture of positive control. The fundamental components of internal control—planning, implementing, supervising and monitoring—are also embodied in the Management Improvement Programs developed by each agency. Advising management on areas at risk, performing audits of operations and recommending ways to improve operations and strengthen internal controls are becoming an integral part of the work of the internal auditors.

2.114. Nonetheless, the system is still evolving and developing in tandem with the financial administration reform. Areas needing attention include active follow-up to ensure that recommendations are fully implemented so that all levels of management understand the benefits resulting from the internal audit activities; closer coordination of internal audit with the CGR so that each performs its role more efficiently and economically; and more periodic reviews of the quality, utility and effectiveness of the internal audit units to ensure their value added. An adequate legal basis for internal control and audit also needs to be established.<sup>37</sup> ( See Annex 2, Internal Control and Internal Audit.)

### Recommendations on Internal Audit

2.115. To preserve the advances made to date a firm legal basis for internal control and audit should be established in an organic law or incorporated in the LAFE which does not cover internal audit. Also, to institutionalize internal audit, arrangements should be developed for internal audit staff to be managed as an overall resource, with a career

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<sup>37</sup> Some observations in Annex 2 relating to Internal Control and Internal Audit are based on a more in-depth review of the functioning of internal control in selected organizations – INDAP, Eastern Metropolitan Health Service, and CORFO

structure, mobility of staff between internal audit units, and adequate centralized training, while preserving the basic current model of decentralized operations (internal audit units located in and reporting to agency management) and centralized monitoring and overview (through CAIGG and Ministerial Auditors).

## **EXTERNAL CONTROL**

### **Overview**

2.116. The Contraloría General de la República (CGR), Chile's Supreme Audit Institution (SAI), is a well-respected autonomous audit office which has played an important role in strengthening public financial management in Chile and helping to build Chile's justifiably high reputation for probity and fiscal transparency. Over the years the CGR has not been afraid of embracing change and, as can be seen by its willingness to embark on a major IDB-supported modernization project, continues to seek ways to provide an ever better service to the Congress, the Ministries and other government entities, and ultimately the people of Chile, while preserving its capacity to fulfill its mission objectively, efficiently and effectively .

2.117. However, the world is changing rapidly. Across the Chilean public sector, there are major improvements in financial management, internal control and internal audit, performance measurement, programmed evaluation and public reporting. Elsewhere in the world there are wide-ranging changes occurring in public audit as auditors seek to harmonize audit standards with the private sector, develop new products and approaches to monitoring the ways governments raise and use public monies, disseminate best practices, and better keep civil society properly informed on how their taxes and public assets are being managed. The examination of the CGR, its current activities and its future plans, shows that the CGR is responding to many of these developments.

2.118. However, to continue as one of the world's leading public audit institutions, the CGR will need to consider engaging even more fully with reforms emanating from within Government, the Congress and Chilean civil society. As part of this process, the CGR may need to review its current wide-ranging functions to determine which it alone needs to continue to fulfill, like the oversight of government reporting and investigation of malfeasance, and which, in the light of other fundamental reforms emerging in public administration in Chile, may no longer be needed, like the ex-ante review of administrative acts, or which could be better carried out by other agents, as in the case of financial statement reporting. However, modifying CGR's mandate and activities poses constitutional issues that would make very difficult to implement most of the simple solutions to this problem. The Chilean authorities need to consider their options, and come up with a solution that balances the need for transparency and independence as prescribed by INTOSAI principles and accommodates country constraints.

### **Audit Mandate and Role: Functional Independence**

2.119. To comply with international best practices on independence, an SAI must have, and be seen to exercise, constitutional guarantees of independence, functional or

operational independence, managerial or administrative independence, freedom of reporting and financial autonomy. The framework in which the CGR operates is broadly in line with these standards. ( See Annex 2 Audit Mandate and Role: Functional Independence).

### **Functions of the CGR**

2.120. The CGR is a highly complex organization because of the varied and unusually wide rang of functions it carries out. These include:

- Pre-approval of expenditure and other administrative acts in order to ensure their legality and constitutionality (the Toma de Razon procedure);
- Maintaining a registry of all laws, and vetting that secondary laws are constitutional and legal;
- Compiling the general accounts of the nation from information provided by central government, public enterprises and local municipalities;
- Regulating the national general accounting system, laying down principles, rules and technical procedures;
- Establishing guidelines for internal audit and internal control and training internal audit staff; and
- Conducting ex-post financial audits, concurrent examinations of fiduciary and legal controls of public works, and other special investigations.
- Acting as external auditor of projects financed by multilateral financial institutions.

2.121. In addition to its routine, planned audit activities, the CGR is expected to respond to requests from the Congress and the public to undertake special investigations (inspections). These investigations consume a substantial amount of the CGR's resources and mean that much planned audit work is not completed. The results of the audits and inspections are provided first to the audited organization and then provided Congress where the corresponding Congressional Commission reviews. Under the modernization initiative in the CGR, public reporting through the CGR web site will expand to include the reports from the audits and the inspections.

2.122. The CGR operates on the assumption that all such requests must be fully acted on. It has not sought to actively manage demand for these special investigations, by for example, ensuring that Congress is fully aware of the impact of such requests on the routine audit work, or by developing criteria to use in assessing whether such requests may be better routed through other services or dealt with in other ways. ( See Annex 2, Functions of the CGR)

### **Modernization Plans**

2.123. The CGR is a well-respected institution which has played an important role in strengthening public financial management in Chile and helping to build Chile's justifiably high reputation for probity and fiscal transparency. However, it is also seen by

others as a somewhat traditional and aloof institution, staffed by competent and committed staff but not always actively engaged with the major developments in public sector management and auditing. It is seen as doing a good job but a narrow job. The CGR has recognized that it needs to modernize by issuing a *Doctrina Institucional* in October 2003, outlining high-level policies and directions for each of the institution's major functions, and embarking on a major modernization program. This project is aimed at improving the CGR's management systems and enhancing the institution's efficiency and operational effectiveness. In particular, project components aim to improve the CGR's approach to strategic planning, help upgrade and integrate IT systems, establish modern human resource management procedures and practices, modernize some of the Regional Offices of the CGR, and improve communications with key stakeholders.

2.124. As part of strengthening its strategic planning processes, the CGR could do more to enter into dialogue with the Congress and key external stakeholders in the public sector and civil society about how the CGR can exercise its role better and contribute to the more efficient and effective use of Chile's public resources. It is crucial in producing its strategic plan that it demonstrates both through the way the plan is developed and what is said in the plan that it is aware of, and engaged in, the changing world of public sector audit and public sector reform of which it should be a critical part. It should also ensure that the strategic plan is supported by detailed implementation plans which are clearly linked to the CGR's budgeting process and which set challenging delivery schedules with named staff members responsible for delivery of individual components of the plan and with rigorous review arrangements by senior managers. There are considerable benefits for the CGR to demonstrate publicly that it cannot only practice what it preaches but that its practices are better than others.

2.125. Over time, the CGR has progressively relaxed its ex-ante control systems, delegating to Ministries and others rights to approve individual items of expenditure up to some US\$ 250,000. These delegations recognize the growing maturity of internal controls with the Chilean public sector. As internal audit units in Ministries and Services mature (see the discussion in Internal Audit) and as Ministry of Finance led control systems, for example SIGFE and SIAPER (see the discussion in Budget Implementation) come to fruition, the CGR may be able to consider further ways in which it might reduce its efforts on ex-ante controls and build up a broader portfolio of ex-post audit services. Examples of such work exist in the CGR and are to be encouraged. ( See Annex 2, CGR Modernization Plans, CGR Organization, Management and Resources.)

## **Audit Process**

### Audit Methodology

2.126. The CGR does not audit all government entities annually, but targets its resources on the basis of a risk assessment which is based on the results of prior audits and knowledge of the work of the internal auditors, the size of an entity's budget, inherent operational risks, sensitivity or impact of the area, and the importance attached to the area by the government. The audit planning and execution procedures are consistent with

INTOSAI auditing standards and the CGR has developed a rigorous framework for monitoring the time and staff resources used on each audit.

2.127. There are no audit opinions on any of the Chilean general government financial statements, including the aggregate ones prepared by the CGR itself. Also, the CGR is retreating from financial statement audits of the principle public enterprises (ENAP and ENAMI), which represent 60 percent of the turnover of the public enterprises included in the Annual Financial Report of the Republic. The audit of these and CODELCO, where the CGR has no mandate, are performed by private audit firms. This development may imply less assurance for stakeholders, given the concerns on the requirements to qualify as statutory auditors for listed companies and the regulation of the audit practice in Chile reported in the 2004 Chile Accounting and Auditing ROSC. In part this is a result of capacity constraints, in part a question of demand. However, assessing the extent to which the accounts of government bodies in Chile are true and fair would exert a useful discipline on public entities in Chile, encouraging accounts to be completed promptly and accurately. Such opinions would also assist the public sector modernization agenda of the government and the Congress and would greatly enhance Chile's international reputation for propriety.

2.128. The CGR has the technical capacity to provide such opinions but, at least in the short term, it may lack the staff resources. In this regard, Chile is progressively upgrading internal audit within government departments. CGR examinations have shown that at this stage the quality of internal audit is variable but over time there should be improvements. As this happens, the CGR should be able to place increased reliance on the work of internal audits and move to a risk-based audit of systems, thus reducing the need for extensive transaction testing.

2.129. CGR might need to move forward on opinions of the financial statements on an incremental basis. Initially it might consider providing an opinion on the Statement of Budget Execution of the national budget, working with individual public entities to ensure that their reporting systems were adequate. It might also consider introducing a rolling program, giving opinions on individual accounts perhaps once every two to three years. This latter approach would at least avoid the lack of independence of CGR associated with the Annual Financial Report which the CGR prepares directly.

### **Enhancing the Role of Congress**

2.130. Since the CGR is not an office of the legislature, as SAIs are under the model followed in many OECD countries, one of the major challenges facing the CGR is how it can develop better ways of ensuring that the legislature takes more note of its findings and uses the CGR in an appropriate, non-party political way to scrutinize the activities of the executive. Already the CGR's findings receive press coverage and are the subject of heated debate. By focusing on cross-cutting issues common to many government activities and entities, the impact of the CGR's work could be greater. In many countries, the legislature receives reports from the Supreme Audit Institution and, in a responsible, but challenging way, uses these reports to encourage improvements in the management of public resources. The CGR could use the current modernization project to open up a

dialogue with Congress on this issue and seek to set in motion, changes which could dramatically increase its impact and utility.

### **Recommendations on External Audit**

2.131. The CGR should review its current wide-ranging functions to determine which ones it alone needs to continue to fulfill and which, in the light of other fundamental reforms emerging in public administration in Chile, may no longer be needed or could be better carried out by other agents. Specifically:

- the CGR could relinquish the a priori review function as the quality of internal control in the service agencies improves with the strengthening of Internal Audit, moving to depend on the review of internal control and testing for its consistent application to arrive at assurance of the reliability of control and reporting.
- similarly, with the uniform and reliable transaction reporting and centralization of accounting permitted by SIGFE, CGR may permit the Executive to prepare its financial reports and thus strengthen its position as an independent reviewer.

These changes of mandate would enable CGR to avoid a potential conflict of interest particularly between the preparation of accounts and their audit, which is not compliant with INTOSAI principles. However, modifying CGR mandate and activities may be difficult in view of CGR's strong reputation and the constitutional issues related to the role of CGR. The Chilean authorities should consider addressing this matter with a solution that balances the need for compliance with international practice and accommodates country constraints.

2.132. CGR does not have a mandate to audit the Central Bank, the Banco del Estado or to review CODELCO, the National Television Corporation or the State Railway Company. Given the CGR's responsibility to provide assurance on administrative acts, any limit in its scope is inconsistent. This limitation is of more concern given the weak state of control over who can exercise the role of an external auditor in Chile.

2.133. To address the issue of CGR financial independence, an INTOSAI principle, the Chilean authorities should study how other INTOSAI member countries treat this subject. Any proposed changes to the current CGR budget process should take into consideration Constitutional implications.

2.134. The CGR should actively manage the demand for the special investigations (inspections), ensuring that Congress is fully aware of the impact of such requests on the routine audit work, on one hand, and by developing criteria to use in assessing whether such requests may be better routed through other services (internal audit) or dealt with in other ways.

**2.135.** The CGR should move to providing audit opinion on the financial statements of the general government sector and should campaign for adequate funding to cover key

public enterprises while concerns persist over the regulation of the audit profession. On the general government sector, initially it might consider providing an opinion on the Statement of Budget Execution of the national budget, working with individual public entities to ensure that their reporting systems were adequate. It might also consider introducing a rolling program, giving opinions on individual accounts perhaps once every two to three years.

**2.136.** As part of the modernization project, the CGR should verify that clients are satisfied with the timeliness of audit reports, the appropriateness of recommendations and the quality of the audit work.

### 3. CONCLUSION

#### SUMMARY

3.1. The abundant trust in government in Chile today can be attributed, in part, to two elements of transparency: its fiscal reporting and the incontestable review by a competent, independent authority – the CGR

3.2. The relationship between good governance and better economic and social outcomes is increasingly acknowledged. Transparency - openness about policy intentions, formulating and implementation - is a key element of good governance. The budget is the single most important policy document of governments, where policy objectives are reconciled and implemented in concrete terms. Budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic matter. Recognizing this relationship, in Chile the executive has made a formal commitment with Congress to conform with the OECD Best Practices for Budget Transparency.<sup>38</sup>

3.3. Furthermore, Chile has effectively centralized policies and procedures to support aggregate fiscal discipline. Aggregate fiscal discipline, measured by total fiscal balance or public debt, and the related predictable funding of the budget in Chile has been achieved through a well-developed budget system which provides for a realistic and comprehensive budget.

3.4. The management of service delivery and the corresponding financial operations, on the other hand, is delegated to 190 administratively independent service agencies. The main feature of Chile's public financial management (PFM) operations has been the combination of centralized policies and procedures operated by DIPRES and CGR with decentralized service delivery and financial management operations through 190 service agencies. Although now the subject of a significant reform, DIPRES and CGR use separate, not integrated processes to monitor budget implementation and prepare the financial statements of the central government.

3.5. With the development of a centralized integrated financial management system (SIGFE), the strengthening of internal controls in the service agencies and the modernization of the external audit system, all supported by substantial investment projects from the World Bank and the Inter-American Development Bank, the centralized control can now continue to evolve to greater reliance on accountability for results, with a focus on outputs rather than inputs by the agencies. These developments also allow the functional specialization of the two rector entities of financial management system -

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<sup>38</sup> OECD Member countries are at the forefront of budget transparency practices and drew together a set of Best Practices in this area based on Member countries' experiences. The Best Practices are designed as a reference tool for Member and non-member countries to use in order to increase the degree of budget transparency in their respective countries.

DIPRES and CGR – which now have overlapping functions, which is the case of the CGR, some functions that are incompatible with its ultimate responsibilities as the system's external auditor.

#### Distinguishing Feature of PFM in Chile

3.6. Chile's public financial management is characterized by a unique blend of strengths and weakness. At present, the systems to support the budgeting and accounting in the public sector operating at the agency level are not state-of-the-art and are not uniform across the public sector since they are the responsibility of each executing agency. The systems in place centrally to support fiscal discipline, efficiency and external reporting are antiquated and duplicative between DIPRES and CGR.

3.7. Despite these limited systems, Chile scores high on financial management outputs in fiscal discipline, transparency and supporting efficiency in operations because underlying all financial management operations are clear rules, strict adherence to the rules, dedicated and qualified staff and management which rewards ethical and efficient behavior and there is a matching of responsibility with accountability given the decentralization of financial management to the service agencies.

3.8. As such, Chile has in place the two elements<sup>39</sup> of effective controls systems: workable rules and procedures; and patterns of behavior that accept the rules and procedures as legitimate.

3.9. It is precisely this solid basis of clear rules and behavior in line with the rules that will allow Chile to attain the standards of public financial management which it has targeted (accrual based fiscal reporting and OECD Budget Practices) but it must address remaining issues on the implementation of the new systems and produce an explicit audit opinion on the general government sector financial reports.

#### **CONCLUSION**

3.10. Chile is well into the second generation of public sector reforms. The current focus has moved beyond fiscal discipline to improving public service delivery, that is, the effectiveness and efficiency of government. Such improvements can be built now only because they can rest on the solid existing base of (i) fiscal stability, (ii) predictable financing, and (iii) resource use in line with budget authorizations, with reliable reporting on income, uses and financial position.

3.11. In Chile, the assurance that uses of public funds are in line with authorizations and that there is full and accurate reporting is attributed to clear roles set in law for the executive and the legislature on budget development and oversight, and a clear definition of the responsibilities within the executive for financial management. These roles and rules on the use of public funds are strictly observed and are supported through:

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<sup>39</sup>A Contemporary Approach to Public Expenditure Management, Allen Schick, World Bank Institute, 1999

- An obvious commitment by public sector management to efficiency and transparency in the public sector.
- Incentives in the government-wide Management Improvement Program for building financial management capacity in the service agencies.
- Staffing of financial management positions with qualified professionals in the respective disciplines who operate under clear written rules and regular expert supervision.
- Independent review by internal auditors under the control of the management of each agency, internal auditors under the Executive, and external auditors reporting to agency management, the Executive and to Congress on the legal compliance and probity of all administrative acts.
- Decentralization of financial management to the service agencies, accompanied by well-developed performance measures.

### **Unresolved Issues**

3.12. Notwithstanding the favorable status of financial management, to advance with modernization toward the world's most advanced countries in terms of fiscal transparency<sup>40</sup>, the following issues have to be addressed.

#### **SIGFE**

3.13. Chile is committed to moving to accrual based fiscal reporting (GFSM2001)<sup>41</sup>. In turn, the steps to prepare Chile for accrual based fiscal reporting involve the successful implementation of the integrated financial management (SIGFE), under development, both at the decentralized level and centrally for aggregation and oversight.

3.14. Given that a single system now integrates accounting, budget and treasury, there is a general understanding that a single party must be responsible for the operation of the system and that the existing systems must be displaced by SIGFE. There is, however, no formal commitment to this and no detailed steps have been laid out for its implementation.

3.15. Given CGR's constitutional responsibilities for keeping the accounts of the nation it has to be satisfied that SIGFE meets these ends and has to ensure that it is operating to their expectation on an on-going basis. At the same time, the executive (DIPRES) has a duty to maintain a financial administration information system and control the budget.

3.16. Since DIPRES is responsible for maintaining a financial administration system, it would follow that they operate SIGFE. Arrangements could foresee that (i) DIPRES operate SIGFE and (ii) DIPRES and CGR would have simultaneous real time access to SIGFE data. Under these, or similar arrangements, a detailed formal plan should be

<sup>40</sup> The Director of DIPRES summed up Chile's position on financial management reform in the Report on Government Finances (2003): THE AIM IS TO RAISE CHILE TO THE SAME LEVEL AS THE WORLD'S MOST ADVANCED COUNTRIES IN THE QUESTION OF FISCAL TRANSPARENCY STANDARDS.

<sup>41</sup> IMF (2003), Chile-Staff Report for the Article IV Consultation, paragraphs 29 and 50 and Annex II.

formalized so the arrangements for implementation of the centralized system may be effected. These arrangements would be operational and would not change the responsibilities upon accounting function defined by the Constitution.

#### Project Administration Mainstreaming

3.17. A concrete short term benefit of the full implementation of SIGFE is the possibility for the administration of investment project financed by the multilateral banks to be carried out exclusively through the financial management system of the Service Agencies. This mainstreaming of project administration offers efficiencies and economies to the Government in that no redundant systems are developed or operated for the individual projects.

#### External Audit

3.18. OECD Best Budget Practices cover not only the principal budget reports that governments should produce and their general content but also the practices for ensuring the quality and integrity of the reports. In this regard, Chile is at a variance with the external auditing best practice which states “The year-end report should be audited by the Supreme Audit Institution in accordance with generally accepted auditing practices”.

3.19. For Chile to emerge at the forefront of public sector management, it should issue its annual financial statements with an audit opinion and move to closer adherence with internationally accounting standards in its reporting. The lack of any external audit opinion on the government financial statements is not consistent with a modern approach to public sector external auditing. The independent review is a central pillar of transparency; a key output of the external review is an explicit audit opinion on the financial reports of the general government entities. The accepted medium for expressing the results of this work is to attach the auditor’s opinion, in a format and of a content which conform to international auditing standards, to the financial statements so that users of these statements have this comfort when viewing the statements.

3.20. To render these opinions, CGR would have to distance itself from both the ex ante approval role of budget uses and the preparation of the annual financial statements. This potential conflict of interest between the preparation of accounts by CGR and their role in the audit of these accounts does not comply with INTOSAI principles. However, modifying CGR mandate and activities may be difficult, in part because CGR has a strong reputation, and in other part because of role ascribed to CGR in the Constitution. The Chilean authorities should therefore consider a solution that complies with international practice and accommodates with country constraints.

### **FINANCIAL MANAGEMENT RISK ASSESSMENT**

3.21. The CFAA assessed the financial management risk to Participating Bank funds that are managed through the public financial management systems of the central government of Chile. At issue in financial management risk is whether there is insufficient transparency (quality of information) to determine how public funds were spent or managed. The following was assessed: whether (i) the budget is implemented as

passed; (ii) all significant government activities are covered by the budget; (iii) sufficient reliable information exists on budget execution and (iv) practices match rules. In Chile's public sector, these components of fiduciary risk are managed in the following key cross-cutting areas which have been assessed in the CFAA: budget comprehensiveness, budget realism, adequacy of internal control systems, including information flows; and adequacy of fiscal transparency, both internal and external.

**3.22.** This CFAA establishes that there are many strengths in the Chilean PFM system. These can be listed as follows:

- a strong legal framework in LAFE, the annual budget law and elsewhere, which is invariably observed,
- strong culture of control, reflected in this observance of requirements, the strong constitutional position of CGR and a well developed system of internal audit. Reflecting this, there is a high level of probity in the management of public funds,
- an impressive record of fiscal discipline,
- a realistic and comprehensive budgeting system, operating according to a predictable timetable and rules, which is well understood by participants and which provides good funding predictability to spending agencies,
- a high level of fiscal transparency overall, notwithstanding some omissions concerning the military. Extensive and reliable information on budget execution, and the results and position of the public finances overall is available in a wide range of reports, many of which are on Government of Chile websites,
- a strong focus on performance through the budget, in particular through a well developed system of program evaluation.

3.23. The overall conclusion is that the financial management risk is low; this indicates the substantial institutional capacity of the Chile public sector, strong performance in many fiduciary areas, and the advances made in recent years to improve public sector financial management.

## **GOVERNMENT RESPONSE**

#### 4. ANNEX 1: OFFICIALS CONTACTED DURING MISSION

| Department   | Position   | Name  |
|--|--|---|
| DIPRES   | Budget Director  | Mario Marcel  |
|  | Head of Financial Dept   | Beltran de Ramon  |
|  | Deputy Budget Director   | Sergio Granados   |
|  | Health Sector Analyst  | Jacqueline Canals   |
|  | Education Sector Analyst   | Jose Espinosa   |
| Project SIGFE  | Coordinator of Financial Development   | Leonardo Sanchez Gonzalez   |
|  | Coordinator of Financial Development   | Rodolfo Sepulveda   |
| Ministry of Health   | Director of Planning and Budgeting   | Dr. Claudio Farah   |
| Regional Health Authority East (Servicio de Salud Metro Oriente) | Director of Administration<br>Head of Finance<br>Internal Audit, Chief<br>Internal Audit Unit<br>Internal Audit Unit | Jaime Arriagada<br>Vincente Escobal<br>Dr. Adolfo Brinner<br>Patricio Malinarich<br>Pilar Bizamo O. |
|  |  |   |
| Luis Calvo McKenna Hospital                                      | Director   | Dr. Dolores Toha  |
|  | Deputy Director for Administration   | Diego Sola  |
|  | Head of Accounting   | Elba Zuñiga   |
| Ministry of Education  | Director of Planning and Budgeting<br>Ministerial Auditor  | Teresa Ferrada<br>Andres Rodriguez Ley  |
| Treasury of the Republic   | National Director of Finance   | José Lopez Miranda  |
| National Civil Service   | Director   | Catalina Bau Aedo   |
| National Audit Office (CGR), Accounting Division                 | Accounting Division, Chief   | Pedro Ortiz Gálvez  |
|  | Deputy Head of Accounting Division   | Luis Tellez Mellado   |
|  | Deputy Head of Accounting Division, Standards  | Jose Allende  |
|  | Deputy Head of Accounting Division, Government Accounting  | Jose Aravena  |

|   |  |   |
|---|--|---|
|   | Deputy Head of Accounting Division, Reports and Statistics         | Alejandro Olquin  |
| National Audit Office (CGR) Audit Division, VUOP                                    | Chief<br>Deputy  | Patricio Pérez Fariña<br>Martin Garrido   |
|   |  |   |
| National Audit Office (CGR) Audit Division, Planning                                | Chief  | Margarita Gonzalez  |
| National Audit Office (CGR) Audit Division, Human Resources                         |  | Pedro Sanchez   |
| National Audit Office (CGR) Audit Division Information Technology                   | Chief, Information Center  | Gerardo Vergara Velasquez   |
| National Audit Office (CGR), Internal Audit   |  | Vicente Romero  |
| National Audit Office (CGR), Audit Division, Municipalities                         | Deputy   | Luis Vélis Baeza  |
| National Audit Office (CGR), Audit Division   | Chief<br>Subdivision Chief<br>Subdivision Chief<br>Systems Auditor | Hernán Llanos<br>Jose Fco. Pacheco Navarrete<br>Nelson F. Palominos G.<br>Jorge E. Merida Muñoz |
| Council for Government Internal Auditing (Consejo de Auditoria Interna de Gobierno) | Executive Secretary  | Gonzalo Sánchez G.H.  |
| Ministry of Finance, Internal Audit Department                                      | Ministerial Auditor  | Carlos C. Ogno Canales  |
| INDAP   | Institutional Internal Auditor                                     | Daniella Caldana  |
| Hospital Calvo MacKenna   |  | Adolfo Brine  |
| CORFO   | Head of Internal Control   | Vincente Sánchez Cuesta   |
| Interior Ministry SUBDERE   | Institutional Internal Auditor                                     | Cristian Riquelme Urra  |
| National Treasury Office  | Head of Public Credit  | Sergio Yañez  |
| Superintendencia Valores y Seguros  | Chief, Control Division  | Lucia Canales L.  |
| Professional Accountants' Association (Colegio de Contadores)                       | President  | Dr. Luis Werner-Wildner Q.  |

## 5. ANNEX 2: DETAIL OF THE PUBLIC FINANCIAL MANAGEMENT COMPONENTS

### BUDGET DEVELOPMENT

#### Structural Adjustment Policy

**5.1.** Chile also has a long history of fiscal prudence. Current fiscal policy (a political commitment of the Government, rather than a legal requirement; there is no fiscal responsibility legislation) provides for a *structural* (i.e. underlying, or excluding the impact of short-term fluctuations) budget surplus of one percent of GDP. Necessary adjustments to achieve this target are made to budget expenditures during the year. This structural target enables the Government to pursue counter-cyclical economic policies if it wishes. Two independent professional panels annually determine the calculation of this budget surplus target, one reviewing the effect of the economic cycle on tax revenues and the other determining the expected price of copper, since Chile's fiscal revenues are heavily influenced by the price of copper.

#### Copper Stabilization and Petroleum Funds

**5.2.** LAFE establishes the principle of a unified budget. The budget covers all ministries and autonomous agencies, whose expenditures are appropriated on a gross basis, i.e., irrespective of receipts. There are two funds which operate within the budget:

(1) The Copper Stabilization Fund, set up in 1987 to isolate the effect of changing copper prices on budget revenues. This effect is now of relatively little importance, with any such budget adjustments being governed by the structural fiscal surplus commitment, discussed above. Only a small balance is held in this Fund and its use is governed by a Presidential decree. When economic conditions are good, it is used to repay debt; when economic conditions are less favorable, additional borrowing may be undertaken. Information on transactions of the Fund is provided in the quarterly budget execution statements of DIPRES under a program of Public Treasury. The Annual Financial Report on the Public Sector by the General Accounting Division of the CGR presents only the ending balances of the fund.

(2) The Petroleum Fund, which operates in a similar fashion with the same disclosure as the Copper Fund but is considerably smaller.

#### Budget Timetable

**5.3.** Budget formulation proceeds according to the following regular timetable (governed both by LAFE and the budget instructions issued annually by DIPRES).

**Figure 2. Budget Formulation Timetable.**

(fiscal year begins January 1)

|   |   |
|---|---|
| <b>April-May</b>                            | Updating baselines<br>Initial bilateral meeting between budget office and line ministries           |
| <b>May</b>                                  | President's message to Congress, setting out policy priorities                                      |
| <b>June</b>                                 | Maximum amounts for ongoing programs established by DIPRES<br>Budget Circular issued to ministries  |
| <b>Early August</b>                         | Bilateral meetings between Budget Office and line ministries  |
| <b>Early August</b>                         | Meetings of panels on economic assumptions  |
| <b>End August/<br/>Early September</b>      | Line ministries submit proposals to "Bidding Fund" (if available)                                   |
| <b>2<sup>nd</sup> week of<br/>September</b> | Draft budget discussed with President   |
| <b>3<sup>rd</sup> week of<br/>September</b> | Bilateral ministerial meetings between Minister of Finance and line ministers                       |
| <b>4<sup>th</sup> week of<br/>September</b> | Final preparation of documentation and pricing  |
| <b>Last day of<br/>September</b>            | Budget proposal presented to Congress   |
| <b>Mid November</b>                         | Congress Budget Committee reports to Congress on the Budget proposal<br>Budget approved by Congress |
| <b>November</b>                             | Protocols agreed between DIPRES and Congress  |
| <b>1 December</b>                           | The Budget is formally published  |

Source: OECD 2004 (adapted)

## BUDGET IMPLEMENTATION

### Cash Management

5.4. The Treasury Department within the Ministry of Finance is responsible for tax collection and record keeping of taxpayers, including fines and follow-up on late payments with taxpayers. Taxpayers may remit taxes directly to Treasury or through

agents of the government i.e. commercial banks, as noted above; banks have agreements with Treasury on tax collection service whereby the banks hold funds for three days as compensation for the services rendered. This income and income collected by the service agencies is deposited by the treasury departments of the service agencies in the central revenue account (*Cuenta Unica del Fisco* or CUF), as called for in Title II of the LAFE.

5.5. In addition to cash planning and the cash program, two key instruments are used by Treasury to effect control over revenue; the single taxpayers account and the single fiscal account. The single taxpayer's account (*cuenta única tributaria*) is a sub-ledger of the revenue accounts whereby all tax revenue is noted under the corresponding taxpayer's individual account. Upon collection, direct or by agents, the type of revenue and the individual taxpayer's code is recorded which support the entry in the taxpayers account are the subsidiary ledger level and in the revenue accounts at the level of the general ledger accounts of the Treasury Dept. As such, revenue is identified from the moment of collection to a related tax accounts payable/receivable. There is also a mid-year report from DIPRES to Congress updating revenue and expenditure projections for the current year. This does not lead to any revision of the formal budget allocations, but it may affect the rate of actual budget execution.

5.6. At the time of the approval of the budget, the annual cash outlay program is also set by DIPRES in conjunction with each agency. This cash program is reviewed and updated if necessary by the DIPRES on the 25<sup>th</sup> of the preceding month. On the basis of an annual cash program, updated monthly, DIPRES instructs Treasury to effect the transfers twice a month to the current accounts of the service agencies to cover their operating requirements. The allotments are separated into amounts for personnel and other expenditures and are paid to the agencies in two tranches; the first goes out to pay the salary costs between the 12th and 15th of each month; the balance goes out on the 25<sup>th</sup>. On the salary costs, the agencies effect withholdings for statutory benefit plans and record the related charge to their budgets on a cash basis.<sup>42</sup>

5.7. The monthly cash ceilings are set with the Ministry of Finance without consultation with the spending agencies; however, given the good rate of budget funding (96 percent in 2003) and the flexibility that agencies have for deciding on the uses of the allotted funds, the centralization of setting the cash ceiling is not seen as interfering with program execution. While there is no authority for short term indebtedness, to support the execution in line with approved cash programs, the Finance Dept of DIPRES may sell a portion of its short securities issued by other state entities and repurchase these before year end.

5.8. The Finance Department within DIPRES determines the cash available for short-term investments and in conjunction with the Finance Committee determines the funds to be placed in time deposits with the Banco del Estado on short and longer terms in line

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<sup>42</sup> The amounts related to these withholdings are not transferred to the agencies but held in Treasury until the following month, when they are remitted to the corresponding programs. Although these withholdings are recorded as cash uses in the budget execution, they not actually paid until the following month.

with forecast needs. Short-term fixed rate investments are done exclusively with the Banco del Estado and, as such, are not granted on competitive bidding of yields.

5.9. Once funds are transferred as cash allotments, they are under the control of the service agencies, or the second-tier entities under the agencies, and are not under any direct or indirect control of the Treasury Department. These funds are deposited in non-interest bearing accounts in the Central Bank and the Banco del Estado. Although there are 190 agencies, there are also bank accounts in entities which operate under the services (hospitals for example); the number of active current accounts in the central government is close to 5000.

5.10. Neither the Treasury nor the Finance Department of the Ministry of Finance has access to the banking information and must depend on the monthly financial reports to determine cash balances. The determination of actual balances in the bank accounts is not reported and generally not available to the central authorities. The central authorities estimate the book cash balances once a year, in October, from the initial balance and the actual transfers less actual expenditures reported in the monthly budget execution reports. It is estimated that the idle balances fluctuate between US\$500 and 800 million; no interest is paid on these balances, but in return Banco del Estado provides free banking services and some social services. The relationship with the Banco del Estado is not governed by any contract for services, so there is no separation between the cost of idle balances and cost of banking services rendered to the agencies.

5.11. The procedures in place support the service agencies' autonomy but involve a significant opportunity cost through the idle funds of the average balance in the current accounts of the service agencies. A common practice in commercial banking is the use of zero balancing accounts whereby executing entities under the coordination of a central treasury can draw funds up to an established cash allotment without actually holding funds in their respective current accounts. The central treasury would have on-line access to the movement in all current accounts and ensure adequate funding while at the same time investing all idle funds. The use of these modern techniques and access to short investments at the best risk/rate relationship should be established in new arrangements between the Ministry of Finance and the Banco del Estado.

5.12. Reasonable predictability in budget execution is evident from a review of the following percentages of execution of Original Approved Spending Budgets, for years 2000–2003. Variation by sector from the original budget averages 5 percent, arising primarily from the redistribution of the contingency for pending legislation. Execution by sector on the ending approved budget is also uniformly high; exceptions in 2003 arose for investment spending on CGR (79 percent), as project execution was delayed, and for the Ministry of Economy (75 percent), attributed to variations from budget on financial investment in CORFO.

**Table 1. Planned vs. Actual Spending, Central Government, 2000-03.**

| Year | Total Spending Original Budget | Total Spending Executed | % Executed of Original Budget |
|------|--------------------------------|-------------------------|-------------------------------|
| 2000 | 9,704,558                      | 9,621,337               | 99.1                          |
| 2001 | 10,338,129                     | 10,162,985              | 98.31                         |
| 2002 | 11,210,188                     | 10,494,138              | 93.61                         |
| 2003 | 11,978,684                     | 11,575,879              | 96.6                          |

### Investment Costs

5.13. Ministry of Planning (MIDEPLAN) is responsible for reviewing all central government investment proposals involving budget expenditure. The review is limited to establishing that the project satisfies the demand for an adequate level of return in economic and social terms. Once reviewed and accepted, projects are assigned a unique project number and entered in the project bank. Acceptance does not imply financing but all investment projects included in the budget proposal of an agency must be previously entered in the project bank. The application is Web-based, so once a project is under implementation, the executing agencies can update the project bank with the financial and physical advance. The project bank is not integrated with any other systems. ( Also see Institutional Arrangements para. 2.23.)

### Budget Implementation Health and Education

5.14. Given that budget control, accounting and cash management is decentralized to 190 independent agencies, two ministries – Health and Education - were selected for more detailed review of budget monitoring in the agencies. Their combined spending comes to 30 percent of total expenditure. Their operations involve thousands of payments to thousands of different recipients; such transaction-intensive operations put high demands on the financial management systems and have high inherent risk.

**5.15.** As discussed in other sections, there is general acceptance and compliance with rules on public financial management in Chile. This favorable control environment has allowed a move from the control over budget inputs to a control over outputs based on performance indicators, particularly in the health and education sectors. The distinguishing feature of the budget control in the health and education sectors, which sets it apart from other sectors in Chile and from common budget control in the region, is the absolute reliance on the control over outputs, as opposed to inputs, for their key expenditures. The focus of the central authorities moves from controlling inputs to

controlling outputs, although there is some inconsistency with the ex-ante intervention by CGR on specific types of contracting.

## Health

5.16. The Ministry of Health administers expenditures amounting to over 12 percent of the 2004 budget and has organized its functions under six budget envelopes:

- three support agencies (Public Health Institute, Central Supply Services and Superintendence of Health),
- the Sub secretary of Health, the administrative unit of the ministry and the central funding agency, National Health Fund or FONASA, and
- the Health Service Agencies: clinics and hospitals which operate under the six Regional Health Services.

5.17. FONASA operates the national health insurance program under which all employees contribute 7 percent of their income (up to a specific limit); employees have the right to use this coverage in the public hospitals or to cover a share of the cost of services in private hospitals. The public hospitals offer medical care to those who do not contribute to FONASA and have no private coverage. All funding for the health delivery units is funneled through FONASA and comprises the insurance income, user charges, and subsidies in the form of transfers from the national government.

5.18. Each Regional Health Service is autonomous in its financial management and is assigned a budget and receives transfers from FONASA in line with the budget funding arrangements and service levels/ The Administrative Directorate within each Regional Health Service is organized to support the financial management operations and comprises the human resources, internal audit, asset management and finance departments. The National Health Fund, FONASA, is funded by employee contributions but the transfers to the Regional Authorities are made under the specific programs authorized in the budget, such as Primary Care, Pre-priced Services, Institutional Services and Contingency Programs.

5.19. Primary care funding goes to municipalities for residents who are registered as having no other health coverage. The funding is made on a per capita basis based on the number of registered residents. A technical supervision unit in each Regional Health Authority carries out ongoing supervision of compliance with the service standards of the municipalities and the eligibility of those registered.

5.20. Pre-priced arrangements are used to fund the majority of hospital expenditures and are related to the provision of a projected volume of specific packages of services at an agreed unit cost. The annual budget of the hospital contains the detail on the volume of each package of service. Funding is made against the volume estimated in the budget for each establishment under agreements (*convenios*) with FONASA. Budget may be reallocated by the Regional Health Service among its hospitals to cover service volumes

that are over or under the target volumes. The balance of the funding comes under the heading of Institution Support, which is the amount of transfers or fixed funding that the Regional Authority provides, based on the history of expenditures, less that portion which is converted to pre-priced arrangements.

5.21. Because the composition of contributors and of users is directly affected by variations in income and unemployment variations of the population, the Ministry includes a contingency program which may be drawn on to finance changes in the demands for pre-priced arrangements and other funding to the hospitals. Despite these arrangements, where funding falls short of the recurrent costs required to provide the volume actually materializing, the hospitals have incurred commitments and liabilities beyond authorized budget levels and this has resulted in the accumulation of payment arrears. These arrears can go undetected in the current year but there is now a provision for budget allocation to pay off these arrears.

5.22. The Regional Health Services operate, on one hand, financial management systems to support their own budget and, on the other hand, simple Excel tools to control the approved budgets of the service delivery units under their responsibility, and to aggregate budget execution data.

5.23. In the case of the Eastern Metropolitan Health Service, the financial management system used to support their direct operations is the same as that used by the hospitals: a customized financial and clinic control application comprising the core budget, accounting, and treasury, in addition to inventory, invoicing and clinic control.

While the transfers from FONASA appear as transfers to specific programs and are tied to outputs of volumes of specific services, the uses of these funds in the hospitals are reported in the monthly budget execution reports [along the lines of inputs by very detailed objects of expenditure This practice provides the service delivery units with the cost center and object of expenditure information critical to costing of their outputs.

5.24. As noted, the hospitals have comprehensive financial and clinic control systems in place. A number of these have already implemented the integrated financial management SIGFE system which provides for core budget, accounting, and treasury control.

5.25. Overall then, the health units can count on a flow of funds in line with the volume of service demanded (outputs), and mechanisms are in place to adjust funding to this volume; nonetheless the health units will resort to running up arrears for supplies purchases to meet their service levels. Budget monitoring goes beyond comparing approved to incurred expenditure, since the efficiency of the operations is inferred by comparing the budget outturn (reported by object of expenditure by health unit) to the volume achieved (reported against the performance contract). Given the advantages in supporting results of the pre-priced arrangements, the sector should expand the share of this form of financing.

## Education

5.26. The Ministry of Education oversees 10 agencies (*servicios publicos*) which together form the education sector and represent 18 percent of the national budget (2004). The provision of public primary and secondary education is outsourced to municipal and private schools; this activity is considered a separate agency in the budget presentation. Over 10,000 establishments provide primary and secondary public schooling, requiring a monthly disbursement of around US\$ 200 million that takes us over 60 percent of the education budget and over 10 percent of the national budget. Outsourcing payments are called Subsidies to Education Establishments, and are managed by the Undersecretary of Education.

5.27. Budget formulation for the subsidy is determined in part by the laws, which set out the entitlement to a fixed rate per student days-of-attendance. The rate was set in the 1980s and is tied to the increase in civil servant salaries. This rate is applied to the estimated student population and attendance, calculated on the basis of demographic statistics from the National Statistics Institute and of classroom statistics from the Ministry of Education (numbers of students in each grade who will be advancing to the next level or graduating).

5.28. Budget execution of the subsidy operates through a central system of subsidy control (*sistema de pagos*) managed by the Education Undersecretary, where the records of attendance and payment by establishment are maintained.

5.29. The subsidy control system is updated for changes in the educational establishments supplied by the Regional Education Authorities under the Ministry of Education. On the basis of the validated and authorized set of establishments, the attendance of each establishment is provided on forms that can be read optically to update the attendance records. This input is reviewed and authorized by the Regional Educational Authorities, provided through the Ministry's communication network to the Subsidy Control system, and is processed in the Undersecretary's office under the supervision of the Subsidy Control Unit and the regional authorities. Once processed, the regional payment analysis specifying disbursement by school is provided to the regional authorities.

5.30. The funds relating to the cost per region are transferred from the Ministry's treasury to the accounts of the regional authorities, from which they are withdrawn for electronic transfer to the individual educational establishments.

5.31. The appropriate use of funds under this arrangement depends on the reliability of the information provided by the establishments and the quality of their services as compared to the agreed criteria under which the establishments were admitted to the program. Inspection at the level of each establishment is organized under the Provincial Department of Education and provides an independent evaluation of compliance with the agreed terms of the service and the accuracy of the attendance reported. These reviews are supervised and consolidated at the regional level; at the Undersecretary level, the

reports are used to establish whether the program of inspection of establishments is being carried out in line with the program targets.

5.32. The Ministry has thus successfully implemented a method of planning and funding 60 percent of the budget (primary and secondary education subsidy) that provides excellent predictability, since the both the rate and volume are reliably estimated. At the same time, the volume reported by the providers and compliance with the standards of quality of the service are closely and effectively monitored

## **EXTERNAL FINANCIAL REPORTING AND TRANSPARENCY**

### **Reporting on Military Expenditures**

5.33. The Ministry of National Defense (partida 11 of the national budget) encompasses all the armed forces services. Their operation is funded through the national budget and subject to the LAFE, the administrative and probity laws as well as all budget regulations as with all other decentralized services agencies. Similarly, and the related operations are under the purview of the internal auditor of the executive and the CGR.

5.34. In the following respects, however, there is inadequate reporting on military expenditures.

- The uses of public funds transferred to the armed forces under the Reserved Copper Law of 10 percent of CODELCO's total revenue,<sup>43</sup> destined under law for military equipment, is not reported in the budget documents or in the Annual Financial Report of the CGR. However, under a January 2003 protocol aggregate information on this expenditure will be included in the quarterly budget execution reports prepared by DIPRES. Since 2002 this aggregate information has also been included in the Public Finance Statistics prepared by DIPRES. Although this information is not included in the CGR Annual Financial Report, CGR may review this expenditure and report internally e.g. to Ministers, as appropriate. However it may not report publicly on it.
- The armed forces may borrow to finance equipment purchases (subject to certain limits) but this debt is not included in the public debt statistics or reported in the annual financial report.
- The only reporting on the financial operation of defense enterprises is a summary for each enterprise in the SOE section of the CGR Annual Financial Statement.<sup>44</sup> There are no detailed published or audited financial statements.

### **Reporting by Municipalities**

5.35. Municipalities are subject to the same standards of reporting as central government, set by CGR. Consolidated reporting on municipalities is part of the Public

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<sup>43</sup> CODELCO's revenue came to 3.8 billion USD in 2003.

<sup>44</sup> Total revenue from the three military enterprises came to USD 145 million in 2003.

Finance Statistics published by DIPRES and discussed above. The municipal sector is also part of the Annual Financial Report prepared by CGR; that report contains an aggregate balance sheet and cash statement, the budget results are presented in aggregate and by region. CGR also prepares a quarterly report on municipal budget execution, finances and assets. These are provided to Ministers, DIPRES, Congress and MIDEPLAN but are not formally published. On the other hand, municipalities are required under the Municipalities Act to present an annual Public Account to the Municipal Council and to the community at large in April of each year. This account includes a balance sheet, budget execution statement, detail on investments and key finding of the CGR.

### **Accounting Standards**

5.36. Under the LAFE, the CGR is empowered to set public sector accounting principles and the standards under which the government accounts are kept. Although the Association of Professional Accountants has established a commission on public sector accounting and the CGR will be active member, there are no standards outside of those set by the CGR. Chile is participating in a program with the IDB which includes the alignment of the CGR's public sector accounting standards with the IFAC Public Sector Accounting Standards.

5.37. The current accounting standards issued by the CGR are documented and published in CGR Office Pronouncement 6856/92. These standards aim to apply generally accepted accounting principles to the Chilean public sector. They comprise general principles: identify the economic entity, require accruals based reporting, define the reporting period and attributes of accounting. The Pronouncement also contains principles for specific areas on the valuation of financial and physical assets. The CGR is empowered to provide rulings on accounting treatment where doubts arise. The framework is very limited. In addition to not providing guidance on many specific issues which are provided for in international accounting standards, it does not provide for minimum requirements of financial reports in line with international public sector accounting standards.

### **Managing and Reporting on Public Debt**

5.38. Both external and internal central government debt is managed by the Treasury Department of the Ministry of Finance, where a debt administration system and register has been used since the mid-1980s. The register contains details of each loan and projection of service costs until maturity. The system generates information for preparation of the budget of debt service payments. The loans recorded in the register may be accounted for in either the Treasury Department's general ledger or in the records of a service agency. As such there are no automated outputs from the debt registry for producing accounting reports. The Treasury debt register is also limited to the non-financial sector; it does not include the debt of the Banco del Estado or the Central Bank. Similarly, off-budget debt incurred by the military in relation to equipment purchases is not included and SOEs manage and report their debt separately.

5.39. The LAFE calls for all income to be included in the budget which includes borrowings that are authorized in the Budget law and its annexes. The Annual Budget Law therefore includes an explicit global authorization for public borrowing. Chile has been highly transparent on reporting debt; a comprehensive statistics report on debt, *The Statistical Public Debt Report*, is published annually on the DIPRES website. The Chile Fiscal ROSC concludes that Chile “more than fully complies with the best practice criteria” on public debt statistics set out in the IMF Fiscal Transparency Manual.<sup>45</sup> Information on year end 2003 balances was available within the first quarter of 2004. The report covers debt for the entire public sector: central government, central bank, state enterprises and the pension liability. Summary information on debt of the central government is included in the annual Public Finance Statistics published by DIPRES; this report includes the bonds relating to the vested pension liability. Similarly, a report on debt is produced half yearly for the Finance Committee of the Senate and House of Representatives. This report covers net and gross debt with explanatory notes and background material and is presented within 90 days. Additionally, the Annual Financial Report prepared by the CGR includes a Consolidated Debt Statement for the central government. However, debt incurred in relation to military expenditure is not disclosed in any of these reports..

### **Contingent Liability Reporting**

5.40. Contingent liabilities are liabilities which may arise depending on future events or contingencies. Generally accepted accounting principles, such as IPSAS 19, identify the circumstances in which contingent liabilities should be recognized and how they should be measured and disclosed. While contingent liabilities are not recognized in the balance sheet as liabilities, they should be continually assessed as part of managing budget risks and disclosed in the notes to the financial statements.

5.41. All significant contingent liabilities known to the Government are disclosed in the Budget Director’s Annual Report on Public Finance, except loan guarantees which are disclosed in the Annual Financial Report on the Public Sector by the CGR. These include the state’s share of the minimum pension under the state pension plan and various guarantees to concessionaires of public infrastructure operations. The CGR Annual Financial Report on the public sector includes in the notes to the Consolidated Balance Sheet the total amount of loan guarantees issued by the national government but there is no disclosure of other contingent liabilities. Given the significance of these contingent liabilities and the implicit recognition that there is more than a remote possibility of payment, the CGR Annual Financial Report should contain details of all contingent liabilities.

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<sup>45</sup> Chile: Report on the Observations of Standards and Codes – Fiscal Transparency Module, IMF August, 2003. p. 30

## **Tax Expenditures**

5.42. Tax expenditures are tax concessions to sectors or groups that result in a loss of revenue, and may be regarded as an alternative to direct budget transfers as a form of assistance to these sectors or groups. The Budget Director's Report on Public Finances accompanying the 2004 Budget contains an analysis of tax expenditures. However there do not appear to be any arrangements for their systematic reporting.

## **Asset Management**

5.43. The Framework Law of the Auditor General (CGR) on the Accounting Department's responsibilities calls for the CGR to keep a fixed asset register (*inventario general de los bienes*) and to verify the fixed assets reported therein. However CGR has effectively delegated this responsibility to the individual service agencies and other state entities. The CGR accounting guidelines require the service agencies to record all fixed assets over a specified amount, to maintain administrative control over them, and to conduct periodic physical stocktaking.<sup>46</sup> However within agencies there is considerable variation in the quality of controls exercised over fixed assets. In many cases asset registers are not up to date, no comprehensive physical stocking taking has been carried out, and the registers do not balance with general ledger balances. These practices undermine the reliability of the equity stated in the balance sheet included in the financial reports of each service agency and in the consolidated financial statements of the central government.

5.44. A project with IDB funding is underway to create a centralized comprehensive real estate registry and management system which will contribute to the efficient use of the real estate in the hands of the public sector. This initiative reflects the inadequate state of centralized records and the need to assign costs to real estate occupied by the service agencies in order to support results-based management. The Accounting Department of the CGR, as the authority for accounting and financial reporting, should complement this initiative with an effort to integrate the fixed asset controls (once brought up to date) with the accounting module of the SIGFE system that is being implemented throughout the central government.

## **INTERNAL CONTROL AND INTERNAL AUDIT<sup>47</sup>**

### **Internal Control**

5.45. The Chilean Professional Accounting Organization issued Chilean Generally Accepted Government Auditing Standard (GAGAS) No. 9 "The Study and Evaluation of

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<sup>46</sup> Oficio CGR No 6856 de 1992

<sup>47</sup> Some observations in Annex 2 relating to Internal Control and Internal Audit are based on a more in-depth review of the functioning of internal control in selected organizations – INDAP, Eastern Metropolitan Health Service, and CORFO

Internal Controls” in December, 1986 and Standard No. 14 on “Audit Standard for the Internal Control Structure” in 1995.<sup>48</sup> According to Chilean GAGAS, the internal control system includes an organization’s plans, including all methods and coordinating measures adopted to protect its resources, ensure accuracy and reliability of information systems, contribute to efficient operation, motivate compliance with established policies, and healthy management practices directed by senior management.<sup>49</sup>

5.46. COSO is the internal control framework used by the majority of the Chilean ministries and services.<sup>50</sup>

5.47. Internal control policy is set by the Council for General Internal Government Auditing (see below) which also oversees internal audit throughout the executive; CGR is responsible for the independent review function, exercises legal control over execution of the budget but also exercises ex-ante approvals of many administrative decisions, and evaluates agencies’ internal control systems as part of the external audit process.

5.48. Law No. 19.553 (February 1998) which established the mandatory Management Improvement Programs (PMGs) has played an important role in strengthening internal control. Article 6 states that the head of each service must present to the Minister a yearly PMG that will contain, at a minimum, the institutional mission, the medium and long-term strategic plans, and the annual objectives for management, institutional efficiency and quality of services provided to users, with relevant performance indicators. The program is connected to a merit pay system linked to compliance with management goals, which include several of the systems that comprise the internal control system. Thus improvement of planning, monitoring and control is an important aspect of many PMGs. Validating achievement of these goals through reviewing the performance indicators is a function of the internal audit units.

5.49. The concept that a strong internal control structure is fundamental to the control of the organization and its successful operations appears to be generally accepted by government managers. An excellent example of this was the April 2004 seminar of the Sub secretary of the Ministry of Education, which focused on the role of internal control in the delivery of the educational services. It was attended by the heads of the Ministry’s five divisions and led to the formation of a Consultative Audit Council.

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<sup>48</sup> Law No. 13.011 obliges the Colegio de Contadores de Chile to “issue standards related to the professional exercise of accounting and auditing in Chile.

<sup>49</sup> Technical Document No. 3.

<sup>50</sup> COSO broadly defines internal control as: “a process, affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.

## Internal Audit

5.50. Internal auditors are a part of a governmental organization's internal control framework, but to preserve their independence and objectivity they are not responsible for implementing specific internal control procedures. Their role is to audit internal control policies, practices, and procedures to assure that controls are adequate to achieve the organization's mission.<sup>51</sup> As such they provide important information to top management of the organization.

5.51. There are three main components to the Chilean government internal audit function

- (1) the Council for General Government Internal Auditing (CAIGG),
- (2) Ministerial internal auditors, and
- (3) Internal audit units of individual agencies or enterprises.

5.52. The importance of internal audit was strengthened by the creation of CAIGG in 1997 through a Presidential decree<sup>52</sup> as an advisory entity to the President to coordinate government internal control and government internal audit. A further Presidential decree in 2003 requires all Ministers, Sub secretaries and Heads of Service to fully collaborate with the CAIGG and ensure that it is informed of all areas of risk in each institution and the actions being taken to mitigate those risks. Nevertheless current work on internal control and audit is based on Presidential decrees, which despite their importance do not have the force of law and can be readily changed or dropped. Consideration should be given to developing a law on internal control and audit, as applies to other components of the public financial management system. For example internal audit is covered in Organic Law on municipalities.

5.53. The CAIGG is composed of a Council, Technical Committee and Executive Secretariat. The Council consists of a group of nine high-level public officials chaired by the Budget Director, plus the Executive Secretary. The Technical Committee is made up of the ministerial internal auditors from each of the 13 sectoral ministries and is chaired by the CAIGG Executive Secretary. The CAIGG has a staff of 15, mainly specialists in management, auditing and law. The Executive Secretary's position is now entitled "Auditor-General," reflecting an envisaged strong coordination and policy role for CAIGG.

5.54. The CAIGG acts as advisor to the President on establishing mechanisms that will identify and detect possible weakness in the government control function. It undertakes work in three main areas: audit, transparency and probity. (In the latter area monitoring compliance with the Integrity Law, identifying ways to recognize infractions early, and providing training on the Integrity Law have been important activities.) It is responsible

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<sup>51</sup> Internal Control: Providing a Foundation for Accountability in Government. INTOSAI. 2001.

<sup>52</sup> Supreme Decree No 12, 1997

for preparing the overall General Internal Control Plan for the central government as well as providing the President with information on all of the Annual Internal Audit Plans for the government sectors and priorities selected for each period (see discussion below on internal audit objectives for 2004 – 2005).

5.55. The CAIGG is also responsible for technical advice on internal control. It issues technical bulletins on the development and maintenance of the internal control system, of which 19 have been issued to date and together with seven reference documents are available on the website ([www.caigg.gov.cl](http://www.caigg.gov.cl)). Although it is also responsible for ensuring that adequate training is being provided for all internal audit staff, the budgetary responsibility for training has been passed to the Service or Ministry.

5.56. Ministerial internal auditors are professionals assigned to provide advice to the ministers in areas of internal control and audit and to coordinate the application of the government internal audit policy in all services and organizations in the Minister's portfolio. They are appointed by the Minister and report directly to the Sub secretary, preside over the Ministry Audit Committee, and are a member of the CAIGG Technical Committee.

5.57. Each of the 190 services (ministry, public enterprise or service) has an internal audit unit with a broad audit mandate to evaluate the level of economy, efficiency and effectiveness of institutional resource management and the achievement of the institution's objectives. The actual work undertaken depends on areas of risk identified within the service, but may include compliance auditing, review of systems and performance auditing. There are approximately 570 internal auditors in the central government. They maintain an adequate level of independence with respect to the development of systems and procedures subject to their audit. The head of each unit is appointed by the Head of Service. Most Internal Audit Units report to both the Ministerial Auditor and the Head of Service on a monthly basis. The CAIGG also receives copies of all internal audit reports, as part of its monitoring role.

### **Audit Objectives**

5.58. The President has issued two Government Audit Objectives for 2004-2005 for the entire central government: all internal audit activities should be geared towards ensuring public control over the probity of expenditures, procurement and staff operations; and secondly to carry out all audits that ministers or heads of Service request. These objectives are established on the advice of CAIGG which also monitors their implementation.

5.59. The Ministry Audit Objectives are issued annually by the Minister on the advice of the ministerial internal auditor, and aim to strengthen the performance of the sectoral ministry while providing incentives for adherence to the General Internal Control Plan for the central government. Some ministries may be focused on determining risk in operational systems, others on specific expenditures such as procurement or transfers, and others on preventive systems or improving efficiency. An example of the Ministry Audit Objectives was the Ministry of Health's decision to audit in 2004 the operations of

all the pharmacy units—their organization, procurement processes and controls, inventories and dispensing processes.

5.60. The Institutional Audit Objectives are issued by the Heads of Service and/or enterprise management to meet the specific control requirements of the institution. Each internal audit entity has an annual audit work plan and some have multi-year audit work plans. Although the specific objectives vary from entity to entity, the overall objective of the internal audit unit of INDAP was common to most of the units interviewed: “The work of the Internal Audit Unit has a preventive character and its objective is to add value to what the entity (Service) does, collaborating with the Administration in achieving its objectives within a systemic focus and discipline in order to improve the effectiveness of the management processes”.

5.61. The three levels of internal audit objectives clearly must articulate with each other and be mutually consistent. Ministerial internal audit advisors have a key role in ensuring appropriate linkage between the plans of internal audit units, the overall needs of the ministry and linkage with overall government audit objectives. The process of setting the three levels of objectives thus involves both a “top-down” and a “bottom-up” approach.

### **Internal Audit Operations**

5.62. Compliance with IIA Performance Standard 2000: Managing the Internal Audit Activity, was generally found during the interviews by the CFAA team. Although the process varies from ministry to ministry, once the President (through the CAIGG), the Ministers and the Heads of Service issue their audit objectives for the period, the Internal Audit Units prepare their annual work plan based on a risk analysis, using the COSO methodology. In some cases, the proposed plan is approved first by the Head of Service, while in others, it may go to the Audit Committee or Ministerial Auditor. The Ministerial Auditor, as a member of the CAIGG Technical Committee, provides the information on the internal audit activity. Generally the audit resources are appropriate, sufficient, and effectively deployed to achieve the annual plan. Each unit has manuals on policies and procedures as required by law.

5.63. The size of the Internal Audit Unit varies from service to service. INDAP has nine professionals in Santiago and two in each of the six most important regions. However the Eastern Metropolitan Health Service has only one auditor for seven hospitals. CORFU has 10 staff professionals, 10 auditors from a private audit firm that are assigned to CORFU full-time, and an additional contract with a private auditing firm for the equivalent of a further two to three audit staff.

5.64. The internal audit activity appears to assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement as stipulated in the IIA standards. The 2003 work plans include a range of issues reflecting the broad scope of internal audit work—legality of administrative acts, administrative and control weaknesses, ways to improve client service, procurement policies and procedures, verification of Ethic Committees and their

relationships with government officials, verification of debt at December 31, 2003 and always, the follow-up of recommendations from previous audits.

**5.65.** The relationship between the Internal Audit Units, Ministerial Auditors and CGR varies from formal to close depending on the service and the number of audits carried out by the CGR in the institution, i.e. since the scope of substantive testing is based on the compliance and internal control quality in an audit. In entities such as the Ministry of Education, where CGR auditors maintain a full-time physical presence, there is a greater degree of informality. CGR has full access to and uses internal audit reports where appropriate. The CGR has also provided technical training and provided speakers to many of the units. All CGR audit reports are sent to the Ministerial Internal Auditor.

**5.66.** The CAIGG's assessment is that the quality of internal audit work has improved greatly over the last two years. However, it considers it too early to judge whether impact is increasing at the same rate. Lack of staff numbers in some services is a limiting factor, but this can only be addressed through increased funding for internal audit units. CAIGG is also concerned about lack of funds for external training, the need to ensure that internal auditors are sufficiently independent of their own organization (for example, their role in validating the achievements under Management Improvement Programs on which salary bonuses within their organization occur may put them under undesirable pressure), and the need to create a career service with staff mobility across internal audit units.

5.67. On this latter issue, there is now some discussion as to whether internal audit staff might be part of the MOF, rather than formally attached to their respective services. The present Chilean arrangements have the advantage of firmly anchoring internal audit as a tool of agency management, which is consistent with current corporate governance concepts. Pertinent to this is the use of an Audit Committees or similar body to ensure the impact of internal audit work within the agency. At the same time in Chile, the existence of Ministerial Internal Auditors and the CAIGG, and the setting of internal audit objectives at three levels, provides some central overview of this work, to ensure its quality and relevance to the government overall. Thus the present arrangements appear to combine the best features of both a centralized and decentralized system, although CAIGG's concerns mentioned above should be addressed.

## **EXTERNAL CONTROL**

### **Audit Mandate and Role: Functional Independence**

5.68. The CGR was founded in 1927 as a co-equal branch of government and its functions are established in the Chilean Constitution. The Office of the Comptroller General performs its functions autonomously, but it does not have independent legal status and acts under the Treasury's legal mandate. Given the constitutional status of the CGR, the rules governing its organization and functioning have the rank of constitutional statutes. Its charter (Law 10.336), and subsequent amendments, set out the objective and organization of the Office, its staffing structure, specific regulations on collection and payment of public funds, the responsibilities of staff, guarantees on fulfillment of duties and obligations, scrutiny and audit of public accounts, investigations and enquiries. The

CGR is headed by the Comptroller General who is nominated by the President of the Republic, and approved by the Senate. The Comptroller General does not have a fixed term of appointment, although he or she currently must retire at 75 years of age.

5.69. The CGR is functionally independent of both the executive and the legislature. It determines what it examines, and how and when it carries out such examinations. Its audit coverage is extensive and includes the revenue and investment of public funds, some 190 central government service agencies, 24 public enterprises, eight mixed ownership companies, some 340 municipalities, the public universities, concessions granted by the Government to agencies for the exploitation of public resources, as well as the powers to examine the use made of public monies by non-government organizations and private companies. It does not audit the Central Bank, the Banco del Estado or have mandate to review CODELCO, the National Television Corporation or the State Railway Company. The CGR review the operations of the military equipment purchases but cannot report publicly on its findings. It undertakes audits of loans and grants provided to Chile by international banks and donor agencies. It has extensive powers to obtain the release of documents and other information if auditees are reluctant to release such data.

5.70. In addition, the Comptroller General has extensive managerial powers including the powers: to select a deputy or Sub comptroller; to recruit, promote and dismiss staff; and to set salary levels and other terms of employment. Both the two top positions at the CGR must be occupied by lawyers. The Comptroller General and Sub comptroller have the prerogatives and legal protection enjoyed by High Court Judges.

5.71. Annually, the Comptroller General must provide a report on the budget and a report on the activities of the CGR to the President and both houses of Congress. Heads of regional offices of the CGR must produce a similar report on their operations for the regional governments. The Comptroller General may also release other reports as he sees fit bringing them to the attention of Congress, the media or the general public.

5.72. The CGR's budget is negotiated with the Ministry of Finance, who present it to Congress as part of the national budget for central government. Congress may propose budget cuts but not increases. This entails a conflict of interest, and the Supreme Audit Institution is not independent as prescribed by INTOSAI principles. There is therefore scope for Chile to look at how other INTOSAI member countries finance their Supreme Audit Institutions in order to foster their financial independence. However, changes to the current CGR budget process would have a high probability of Constitutional implications and therefore be difficult to implement. The Chilean authorities should therefore consider a solution that complies with international practice while also taking into account of country constraints.

### **Functions of the CGR**

5.73. In 2003, the CGR reviewed 177,804 administrative acts through the *Toma de Razon* function, and issued 20,012 legal opinions and instructions. CGR inspections and audits implied visits to 1,288 different organizations and gave rise to 6,373 audit and inspection reports, of which 2,731 related to regular audits, and 3,642 were specially

requested. In addition, during this period, the CGR processed 41,139 accounting reports, issued 589 accounting instructions and responded to 408 inquiries.

5.74. Its ex-post audit activities are mainly connected with reviewing the financial accounts of audited bodies and the adequacy of internal controls. It also carries out reviews of IT systems. It has no statutory requirement to, nor does it, undertake performance audits or value for money studies, though equally it is not precluded from examining and reporting on efficiency and effectiveness issues as an adjunct to its financial audits or as self-initiated special investigations. It has always performed the external review of investment projects under terms of reference agreed with the IDB and the WB. This review is regularly reviewed by the Banks and is considered of high quality.

5.75. As noted above, 3,642 different engagements were requested in 2003, this is 911 more than the audit engagements. In 2003, approximately, 10 percent of the requests originated with Congress, where they arise during debate, 30 percent of the requests come from the executive, 40 percent from private parties and 20 percent from within the services agencies. In 2003 for example, inspections were requested by Congress on the use of fiduciary funds for equipment purchases by the National Firefighters Corps, inspections also covered: advances for works to the University of Chile, the cash management operations of National Petroleum Company and the training contracts in the Post Office.

### **CGR Modernization Plans**

5.76. The Division de la Vivienda y Urbanismo y Obras Públicas y Transportes of the CGR in February 2000 produced a report summarizing key findings emerging from its audit of public works concessions. The CGR could usefully produce more such reports identifying common themes and lessons which emerge from its financial and regularity audits. For example, are there common themes emerging in commissioning, developing and introducing new hardware and software initiatives which could be extracted from a range of different audits and disseminated to all government entities. The impact of this work could be further enhanced by giving more attention to presenting such information to Congress and Ministries in accessible formats and through varied media, including special conferences, and short-targeted publications or checklists. There is scope for the CGR to validate performance information reported to the Government or add further value by carrying out audits to test, for example, the robustness of the systems providing such data. Furthermore, as the lead auditor of municipalities, the CGR could do more to produce and analyze comparative data on the relative performance of municipalities across the country.

### **CGR Organization, Management and Resources**

#### Peer Review

5.77. The CGR is required by its own organic law to report annually to the President and Congress on its performance in the annual Public Account (*Cuenta Pública*) wherein

he details principle activities, major issues on the application of the administrative laws, and other issues on control reported at the discretion of the Auditor General. However, it is not routinely subjected to external audit or review. While this guarantees its independence, it also means that the CGR is not formally and regularly placed in a position whereby it has to justify itself and demonstrate its contribution to the Chilean people. Many SAIs elsewhere are subjected to regular external audit and/or periodic peer reviews. The CGR may need to consider whether such an approach is merited in Chile.

The CGR is one of the few audit institutions in the region to have created its own internal audit function. The impact of the internal auditors work and its independence could be enhanced by adopting good corporate governance practices whereby internal audit units report to an audit committee, which itself reports directly to the Comptroller General.

### Management

5.78. The CGR has an annual budget of some US\$22 million. It employs some 1,400 staff across its central office and 12 regional offices. Of these, some 400 are professional auditors, just over half of whom are based in Santiago. Other staff are involved in legal work and general administrative functions. The CGR also employs engineers, quantity surveyors and other experts to assist with the monitoring of major public works projects.

5.79. The CGR's ex-post financial audit function is carried out by three major divisions in Santiago, and the 12 regional offices. The Central Division of Administrative Audit plans and executes, with assistance from the regional offices, financial audits of the central government Ministries and associated entities. The *Division de la Vivienda y Urbanismo y Obras Públicas y Transportes* (VUOPT) audits major public works across different ministries and services, and the Municipalities Division audits the 52 Municipalities in the Santiago region, as well as setting overall policy for the audits of municipalities carried out by the Regional Offices.

5.80. While there is scope for improvements in the way the way the CGR captures and uses internal management data, the organization has a solid foundation for an integrated computerized management information system. It routinely and systematically collects data on the use of staff time on different audits and can compare planned and actual activities and the cost of audit.

### Human Resources

5.81. The CGR is an attractive environment in which to work and there is no difficulty recruiting staff. Most of the audit professionals have university qualifications, mainly in accounting, audit or business and CGR staff are heavily involved in lecturing on such courses. Once staff join the CGR they are provided with a three-month induction program and then regular opportunities for continuous professional development. The CGR has made a firm commitment to providing staff with professional development and training opportunities and staff are expected to undertake some 40 hours of training each year. However, meeting this expectation is not embedded in CGR staff management systems

and has no direct link to achieving annual bonuses or promotion. As part of the modernization project, plans are underway to review the CGR's training needs and its general approach to training. This exercise will enable the CGR to seek feedback from clients on the extent to which CGR staff skills are perceived to be adequate and to check that staff have the skills needed to rigorously audit accrual accounts.

5.82. Wages are above the average for other civil servants and there is little turnover. Furthermore, pensions are low and people do not retire early. The average age of staff in the CGR is 45 and the oldest staff member 77. While providing a valuable pool of expertise, this situation provides few opportunities to bring in and promote younger staff and makes it difficult to dislodge under-performing staff. As part of the modernization project, the CGR is seeking ways of helping staff over 60 to retire. It is trying also to maintain the skills and enthusiasm of staff by starting to rotate staff between audit areas. This needs to be more vigorously pursued, and monitored. The CGR might wish to consider introducing a formal limit to the number of years any auditor can spend on any one account. Another way movement could be encouraged, and the CGR skill base enhanced, might be through a formal program of secondment to private, public, NGO or international agencies. The CGR might like to consider linking promotion to having undertaken a period on external secondment.

5.83. The CGR has the powers to hire consultant specialists and to contract out audits and has indicated in its *Doctrina Institucional* that it wishes to use such measures. Both offer ways in which the skill base of the CGR can be enriched. Hiring consultants can bring specialist skills to bear on particular audits, while contracting out audits provides an opportunity for an organization to compare its own procedures with those of the private sector. However, neither of these options has yet been used by the CGR.

## **Audit Process**

### Audit Methodology

5.84. Building on the INTOSAI Auditing Standards, the CGR has developed an extensive range of audit manuals and guidance materials which are being progressively updated. It is in the process of creating an audit methodology team with responsibility for co-coordinating audit methodology across the organization and for providing specific technical advice to auditors. It has a five stage audit review program to ensure the integrity of audits. However, no part of the organization is charged with overall audit quality control. The CGR may wish to consider attaching this function to the audit methodology unit with a view to reviewing on a rolling basis, a sample of audits across the different divisions and regions, assessing overall quality and identifying lessons which need to be applied more generally. There is substantial expertise across the SAI community internationally in developing and running such audit quality review teams which the CGR could usefully harvest.

5.85. The modernization programmed is seeking to substantially increase IT capacity throughout the CGR. Increasingly staff will be provided with laptops and will be able to operate away from their offices on the premises of clients and elsewhere. This process

provides an opportunity to substantially improve the quality and reliability of audits by obtaining appropriate audit software and standardizing many of the audit practices. Commercial packages exist which facilitate this move and, by allowing audit managers to access the work of auditors at a distance make quality control easier.

5.86. As part of the modernization project, the CGR should verify that clients are satisfied with the timeliness of audit reports, the appropriateness of recommendations and the quality of the audit work.

### **Increasing Impact**

#### **Performance Indicators**

5.87. For its financial audit activities, the CGR currently records its impacts in terms of the number and types of weaknesses encountered, the number and types of legal proceedings, and the sums recovered. In line with other public sector organizations in Chile, the CGR is currently exploring ways of introducing performance indicators which better monitor the impact of its work. Again the CGR could profitably examine the types of measures in use elsewhere in the SAI community, including measures of financial savings, as well as other quantitative and qualitative impacts. One issue which would facilitate such impact monitoring would be moving from commenting in management letters on what was not working well to making specific recommendation on the improvements or changes which are needed. A greater focus on the impacts would also put pressure on the CGR to develop more robust arrangements for following up past recommendations to ensure that they have been implemented and are achieving the desired improvements.

#### **Public Reporting**

5.88. The CGR produces a wide range of documents, from management letters to reports summarizing achievements. These documents are one of the major windows through which Government, Congress and the general populace view the CGR. However, they are not user-friendly and do not market the CGR well. Regardless of how good the contents of the reports are, if they do not look good they are not likely to be read widely. The CGR needs to establish a modern publishing capability to ensure that all its products carry a common house style and gain a reputation for brevity, clarity, accessibility and overall quality.

## ANNEX 3: BUDGET TABLES

**Table I.2.2.**  
**Revenue Projections, 2004.**

|                                    | Millions of Pesos 2004 | Percentage of GDP | Variation 2004/2003  |                                 |
|------------------------------------|------------------------|-------------------|----------------------|---------------------------------|
|                                    |                        |                   | From Budget Law 2003 | From September 2003 Projections |
| CURRENT REVENUE                    | 11,307,068             | 21.3              | 2.0%                 | 4.9%                            |
| Operating revenue                  | 699.625                | 1.3               | -1.2%                | -3.9%                           |
| Social contributions               | 817.476                | 1.5               | 11.0%                | 11.0%                           |
| Net tax revenue                    | 8,899.209              | 16.8              | 4.2%                 | 6.4%                            |
| Net copper revenue                 | 496.723                | 0.9               | 10.0%                | 67.6%                           |
| Transfers                          | 38.932                 | 0.6               | -57.9%               | -59.4%                          |
| Other revenue                      | 326.644                | 0.1               | -38.1%               | -36.8%                          |
| Operating revenue (previous years) | 28.458                 | 0.0               | 1.3%                 | -27.7%                          |
| CAPITAL REVENUE                    | 177,480                | 0.3               | -13.8%               | -21.3%                          |
| Sale of assets                     | 25.926                 | 0.0               | -16.6%               | -9.4%                           |
| Loan redemption                    | 151.554                | 0.3               | -13.4%               | -23.0%                          |
| TOTAL REVENUE                      | 11,484,548             | 2.6               | 1.7%                 | 4.4%                            |

Source: Budget Office.

**Table I.2.3.**  
**Level and Composition of Expenditures, 2004**

|   | Millions of pesos 2004 | % of GDP | Variation 2004/2003   |
|---|------------------------|----------|-----------------------|
|   |                        |          | From 2003 projections |
| CURRENT EXPENDITURES                    | 9,872,330              | 18.6     | 4.2%                  |
| Operating expenses                      | 2,970,096              | 5.6      | -1.3%                 |
| CAPITAL EXPENDITURES                    | 2,044,248              | 3.8      | 4.6%                  |
| Investment + capital transfers          | 1,847,974              | 3.5      | 6.2%                  |
| TOTAL EXPENDITURES                      | 11,916,579             | 22.4     | 4.3%                  |
| EXPENDITURES WITH MACROECONOMIC EFFECTS | 11,013,451             | 20.7     | 4.0%                  |

Source: Budget Office

**Table 1.2.4.**  
**Central Government Balance, 1997-2004.**  
 (% of GDP)

|   | 1997       | 1998        | 1999        | 2000        | 2001        | 2002        | 2003        | 2004        |
|---|------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Actual central government balance on cash basis                   | 1.8        | 0.4         | -1.4        | 0.1         | -0.3        | -0.8        | -0.8        | -0.6        |
| Actual central government balance on accrual basis                | 2.0        | 0.4         | -2.1        | -0.7        | -0.5        | -1.3        | -0.6        | -0.1        |
| <b>Total cyclical effect on revenues</b>                          | <b>0.8</b> | <b>-0.3</b> | <b>-1.4</b> | <b>-0.8</b> | <b>-1.5</b> | <b>-2.0</b> | <b>-1.4</b> | <b>-1.1</b> |
| Cyclical effect of tax revenues and social security contributions | 0.6        | 0.4         | -0.5        | -0.4        | -0.5        | -1.0        | -0.9        | -0.8        |
| Cyclical effect of copper   | 0.2        | -0.7        | -0.9        | -0.4        | -1.0        | -1.0        | -0.5        | -0.2        |
| <b>Central government structural balance on accrual basis</b>     | <b>1.2</b> | <b>0.7</b>  | <b>-0.7</b> | <b>0.1</b>  | <b>1.0</b>  | <b>0.8</b>  | <b>0.8</b>  | <b>1.0</b>  |

Source: Budget Office.

**Table 1.2.5. Expenditure Budget Execution Statement, Accrual Basis – 2003**  
 (millions of Pesos)

| Budget Unit  | Modified Budget | Expenditure  | Percentage of |                     |
|--|-----------------|--------------|---------------|---------------------|
|  |                 |              | Total         | Execution of Budget |
| Office of the President                                  | 7,400.50        | 7,305.30     | 0.06          | 98.71               |
| National Congress  | 50,607.60       | 50,326.20    | 0.43          | 99.44               |
| Judiciary  | 141,992.40      | 126,798.40   | 1.10          | 89.30               |
| Office of the Comptroller                                | 27,220.70       | 21,384.90    | 0.18          | 78.56               |
| Ministry of the Interior                                 | 390,370.10      | 345,706.90   | 2.99          | 88.56               |
| Ministry of Foreign Affairs                              | 25,468.50       | 23,852.90    | 0.21          | 93.66               |
| Ministry of Economy, Development And Reconstruction      | 834,635.60      | 629,801.80   | 5.44          | 75.46               |
| Ministry of Finance                                      | 178,028.70      | 169,677.80   | 1.47          | 95.31               |
| Ministry of Education                                    | 1,985,430.90    | 1,937,884.00 | 16.74         | 97.61               |
| Ministry of Justice                                      | 262,727.40      | 244,232.90   | 2.11          | 92.96               |
| Ministry of National Defense                             | 1,045,822.40    | 1,016,801.60 | 8.78          | 97.23               |
| Ministry of Public Works                                 | 777,855.90      | 764,187.20   | 6.60          | 98.24               |
| Ministry of Agriculture                                  | 216,398.40      | 207,863.00   | 1.80          | 96.06               |
| Ministry of National Assets                              | 11,744.60       | 10,460.20    | 0.09          | 89.06               |
| Ministry of Labor and Social Security                    | 3,258,004.30    | 3,257,140.70 | 28.14         | 99.97               |
| Ministry of Health                                       | 1,445,654.20    | 1,464,268.90 | 12.65         | 101.29              |
| Ministry of Mining                                       | 25,683.20       | 24,658.00    | 0.21          | 96.01               |
| Ministry of Housing and City Planning                    | 407,199.40      | 390,017.50   | 3.37          | 95.78               |
| Ministry of Transportation and Telecommunications        | 60,102.40       | 53,779.60    | 0.46          | 89.48               |
| Ministry - Government's General Secretariat              | 50,231.60       | 45,618.10    | 0.39          | 90.82               |
| Ministry of Planning and Cooperation                     | 121,890.70      | 116,741.30   | 1.01          | 95.78               |
| Ministry - Office of the President's General Secretariat | 15,882.70       | 15,269.90    | 0.13          | 96.14               |

|                                |                      |                      |               |              |
|--------------------------------|----------------------|----------------------|---------------|--------------|
| Public Ministry                | 47,507.70            | 38,651.30            | 0.33          | 81.36        |
| Constitutional Court           | -                    | 650.70               | 0.01          | -            |
| Regional Elections Courts      | 900.10               | 827.10               | 0.01          | 91.89        |
| Elections Qualification Courts | 149.30               | 142.40               | 0.00          | 95.38        |
| Public Treasury                | 589,775.60           | 611,830.60           | 5.29          | 103.74       |
| <b>TOTAL</b>                   | <b>11,978,684.90</b> | <b>11,575,879.20</b> | <b>100.00</b> | <b>96.64</b> |

Source: CGR Annual Financial Report

## ANNEX 4: SIGFE COVERAGE

## SIGFE COVERAGE (By March 2005)

| ITEMS  | Mar-05     |
|--|------------|
| <b>TOTAL ENTITIES</b>  | <b>390</b> |
| <b>A ) WITH SIGFE AGREEMENT</b>  | <b>371</b> |
| <b>A1 ) WITH IMPLEMENTATION PROTOCOL</b>                                 | <b>339</b> |
| 1.- In Production Environment  | 299        |
| 1.1 In production  | 92         |
| 1.2 Working in parallel with prior system                                | 207        |
| 2.- In Testing Environment   | 8          |
| 3.- Without SIGFE baseline, in Set up stage<br>(Financial and IT)        | 31         |
| 4.- Processes under review   | 1          |
| 5.- Implementation Protocol Signed                                       | 0          |
| <b>A2 ) AWAITING HOMOLOGATION AGREEMENT</b>                              | <b>32</b>  |
| <b>B ) WITHOUT SIGFE AGREEMENT YET:</b>                                  | <b>19</b>  |
| IM05 (Implementation 2005) Protocol is Projected<br>to be signed in 2005 | 19         |