

# REVIEW OF PUBLIC FINANCIAL MANAGEMENT REFORM LITERATURE



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# **PUBLIC FINANCIAL MANAGEMENT REFORM LITERATURE REVIEW**

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## Preface

This review of literature on experience with Public Financial Management Reform was commissioned by DFID on behalf of the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (Sida), the Canadian International Development Agency (CIDA) and the African Development Bank (AfDB). It was envisaged as the preliminary stage of a joint evaluation, and was overseen by a Steering Group of experts from the contributing agencies.

Strong Public Financial Management (PFM) systems are essential to improved service delivery, poverty reduction and to achievement of the MDGs. Effective PFM systems maximise financial efficiency, improve transparency and accountability, and – in theory – will contribute to long-term economic success. Activities range from the preparation and fulfilment of the budget cycle, budget oversight and control, taxing and debt management and procurement, to resource allocation and income distribution, and are increasingly seen as a set of inter-related sub-systems (and organisational and political cultures), rather than a stand-alone activity.

This literature review aims to synthesise the main theoretical approaches and findings from evaluations of PFM reform programmes, and to identify knowledge gaps. The literature reviewed includes academic and technical articles, development practitioner guides, manuals, handbooks and websites. A multi-donor evaluation examining how to strengthen PFM in (and with) partner countries is planned for 2009, and this literature review will feed into that process.

The review seeks to address two sets of information: an overview of models and approaches, and a review of reform experience. It did not prove possible to relate reform experience to the models presented, which represents a significant short-coming in our understanding of PFM reform. In reality, the links between theoretical and practical approaches are weak – in the case of the newer approaches, reform experience has pre-dated the models, and indeed informed their development. The evaluations reviewed here did not make use of theoretical models to inform their evaluation frameworks. It would therefore contribute to the PFM evaluation literature if the forthcoming evaluation was to base its design framework explicitly on recent theoretical models, and our understanding of the institutional basis of each model.

A key purpose of the literature review was to assist with identification of knowledge and evidence gaps which an evaluation might seek to close. However, the report was constrained by a lack of sufficient evidence and analysis, which made it impossible to lead conclusively to a list of clear evaluation questions. The suggested topics for evaluation now included in this literature review – developed in consultation with the Steering Group – represent important areas of PFM reform meriting further examination. Some of the questions go beyond a focus on PFM reform processes, to examine reform outcomes, and the impact of changes in PFM on poverty and the MDGs. There is however no direct link between the proposed topics and either the reform experience or the models presented. These will require further scoping, in conjunction with the needs and experience of the partners participating in the forthcoming evaluation. However, it is hoped that it will represent a useful contribution to the next phase of the work.

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The synthesis report was researched and written by Carole Pretorius and Nico Pretorius. It was managed by James Bianco, with the assistance of all members of the Steering Group.

The reports represent the views of the authors and not necessarily the views of the Steering Group or its members, or the participating agencies.

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Head, Evaluation Department, DFID

## **Acknowledgements**

The main objective of this literature review is to provide a synthesis of current research and evaluations on public financial management (PFM) reform in order to help identify knowledge and evaluation gaps. Given the broad nature of the topic, the review does not deal with any one issue in detail. Moreover, to make the survey accessible to a multidisciplinary readership, efforts have been made to present the more abstract and technical research in a non-technical way. Detailed reference and reading lists are provided for those readers who would like to obtain more information. We would like to express our appreciation to members of the Steering Committee for their comments. In common with all evaluation reports commissioned by DFID's Evaluation Department, the views contained in this report do not necessarily represent those of DFID or of the people consulted.





## **Executive Summary**

- S1 Effective Public Financial Management (PFM) systems are required to maximise the efficient use of resources, create the highest level of transparency and accountability in government finances and to ensure long-term economic success. Recent literature has highlighted the importance of sound PFM systems to service delivery, poverty reduction and the achievement of the millennium development goals (MDGs). In recent years, a significant amount of literature has been written on the topic of PFM reform; however, no work has been carried out recently to synthesise either its main theoretical approaches or evaluation findings.
- S2 The purpose of this literature review, commissioned by DFID on behalf of the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (Sida), the Canadian International Development Agency (CIDA) and the African Development Bank (AfDB), is three-fold. Firstly, to document the current PFM reform landscape, identifying the major underlying theories, significant trends and differences in approaches in developed and developing countries. The second is to identify the main areas of reform under the major PFM components, and to document what is known with respect to the effect of these reform processes, as well as to identify gaps in current knowledge. The final purpose of the literature review is, using the evidence base developed, to assist with the identification of potential evaluation topics and questions. The overarching objective is that it will serve as an input to a forthcoming evaluation of PFM reform processes.
- S3 Although definitions of PFM still differ, there is a growing recognition that it covers not just technical accounting and reporting issues, but rather the overall taxing, spending and debt management of government, which in turn influences resource allocation and income distribution. There is also an increasing trend to see it not purely as a technical system or set of subsystems, but rather a system of multiple role-players, complex relationships and dynamic and inter-related processes. In theory at least, if not always in practice, there is also a realisation that reforming a particular subsystem may have consequences for a number of related areas.
- S4 The review has focussed on literature written in the last ten years. Given that the overall objective of the review is to provide inputs to an evaluation on how to strengthen PFM in partner countries, the emphasis is placed on recent research into PFM reform in developing and transition countries. Experience in Organisation for Economic Cooperation and Development (OECD) countries is referenced, where relevant.
- S5 The following paragraphs provide a brief summary of the various approaches, major trends, reform experience and evaluation gaps.

## **Triggers for PFM Reform**

- S6 The Paris Declaration on Aid Effectiveness, the associated emphasis on the use of country systems, the increasing use of budget support, and greater emphasis on governance and anti-corruption issues, have placed PFM reform in centre stage, both from a poverty reduction and sustainable peace (in post-conflict countries) perspective. For donors, the importance of sound PFM systems in recipient countries also relates to concerns about funds not being used for intended purposes and the associated impact on development effectiveness and their own reputation.
- S7 Triggers for PFM reform include fiscal crisis, public pressure, donor pressure, political change including post-conflict situations and the demands of regional affiliations such as European Union (EU) accession. In a post-conflict situation, for example, the establishment of an overall framework for PFM and economic management is considered to be an important first step for sustainable peace as well as economic growth.

## **Approaches to PFM Reform**

- S8 During the seventies and eighties, OECD countries and some developing countries began to review the management of their public sector. This led to the development of the New Public Management (NPM) model, which emphasises managerial accountability, and was accompanied by the introduction of financial management measures, often referred to as New Public Financial Management (NPFM). Reviews in OECD countries show that the precise direction and speed of these PFM reforms were influenced by the country's political and social heritage.
- S9 By the mid-nineties, there was a general realisation that the transferability of ideas to developing countries using a blueprint approach was beset with problems, and there was a shift to acknowledging the importance of context, and first getting 'the basics right' for each situation. The World Bank's Public Expenditure Management (PEM) represented another approach, which highlighted the need to move from the due process approach, to consider all actors and practices (formal and informal) involved in the budget process.
- S10 By the beginning of 2000, developing country governments and donors began to question why PFM reforms had achieved only limited success. The ensuing search for answers led to the following conclusions. Firstly, that the budget is a political process, not just a technical one, and that in many countries informal behaviour and practices override the formal ones. Secondly, that reform programmes need country ownership and political commitment to achieve real sustainable progress, and thirdly, that donor coordination and harmonisation is essential.

- S11 This improved understanding has led to the development of three different, but potentially mutually re-enforcing approaches to PFM reform. Political Economy models, such as the Drivers of Change (DoC) Approach and the Expected Utility Stakeholder Model (EUSM) emphasise the importance of political context; the Platform Approach focuses more on the sequencing of reform within a specific country context; and the Strengthened Approach defines the relationship and roles of stakeholders in the PFM reform process.
- S12 Evaluations of where a Political Economy model has been applied to PFM reform are limited. DFID, for example, has carried out a number of DoC studies, but it does not yet appear to be possible to verify whether these high-level analyses have been translated into operational strategies and programmes, and the subsequent impact. Both the Platform and Strengthened approaches are comparatively new, and consequently few progress assessments or substantive evaluations have been conducted. However, initial studies show some positive impact and tangible benefits.
- S13 The above models and approaches have essentially been applied to reform of expenditure management rather than revenue administration. NPM, PEM and the Basics First Approach apply predominantly to expenditure management. The Political Economy, Strengthened and Platform approaches are applicable more widely, they have in practice been generally used for expenditure reform. A different set of models have been applied to revenue reform.
- S14 Tax revenue administration ‘models’ have involved organisational changes. The main model at least for African and Latin American countries has been the creation of a semi-autonomous revenue agency (SARA). Another trend in revenue administration has been to organise activities by function e.g. audit services, collections, rather than by tax type e.g. Value Added Tax (VAT) or Income Tax, in the belief that this increases collections and reduces the potential for corruption.
- S15 Claims are made about the positive impact of SARAs; however, attributing increases in revenue collections solely to a new governance framework is difficult, and their introduction alone does not prevent political interference or fraudulent activities.

### **Measuring Change**

- S16 Despite the level of investment in PFM reform in both developed and developing countries, monitoring and evaluation appears to have been comparatively weak. Until recently, assessment of PFM reform progress has been hampered by the lack of performance-based indicators.
- S17 In developing countries, donor evaluations have frequently concentrated on their technical assistance, rather than the impact, relevance or sustainability of the reform itself. Other evaluations have often been based on observation and experience, rather than use of OECD evaluation criteria. This seems to be true across geographical region, although sub Saharan African countries’ reforms seem to have been more extensively monitored and evaluated.

## **Reform Experience**

- S18 The following section summarises reform experience. It is not possible to relate this experience directly to the above models. Reform experience has guided the development of some of the newer approaches and continues to reinforce the need for recognition of country context; however, links between the theory and practice are often tenuous.
- S19 Most of the PFM reform literature now agrees that PFM reform is a long-term endeavour, or even a continuing process of improvement. Progress assessments for heavily indebted poor countries (HIPC) show limited, but uneven progress and stress the need for realistic timescales. Unrealistic timescales were identified as one of the reasons for many PFM reform failures e.g. implementation of integrated financial management information systems (IFMIS). There is concern in some of the literature that Ministry of Finance (MoF) managed PFM reforms are concentrating on the achievement of aggregate fiscal discipline and improvement at the centre, to the detriment of sector requirements.
- S20 Most reforms fail not because of the contents or technical aspects of the reform programmes, but because of the way in which they were implemented. Evaluations have shown, in particular, that PFM reform programmes need to be country-specific, as they cannot be divorced from their historical, political and social heritage.
- S21 Initial evaluations of the medium-term expenditure framework (MTEF) in 2002, showed limited success, because of the highly complex, political and institutional nature of the task. Similarly, OECD experience suggests that performance-based budgeting is having mixed results, because of the need to customise the approach and develop appropriate incentive systems for civil servants and politicians.
- S22 The aim of general tax administration reforms is to increase voluntary compliance, as well as increasing revenue and reducing evasion. Country experience suggests that success requires time, high-level political commitment and public support, and to be embedded in and part of wider public sector reforms.
- S23 Procurement reforms and the modernisation of procurement systems in developing countries has recently received increased attention. Objective indicator-based assessments of procurement practices were only launched in 2008, so the evidence of success is somewhat limited. However, in the Philippines success is reported as being due to strong ownership of less than perfect reform, rather than no ownership of state of the art practices. This underlines the importance of understanding how the political economy functions, although there is no evidence from the literature, of analysis having been carried out to inform procurement reform.
- S24 Support to payroll reforms has concentrated on the introduction of automated systems; however, there appears to have been no evaluation of their effectiveness, either in terms of improving controls or in improving medium-term planning processes.

- S25 In heavily indebted countries, there are reported to be only limited improvements in internal controls, although no clear explanation as to why this has occurred. Debate continues on the best role for internal audit in the public sector. Experience in Kenya and South Africa suggests that the traditional ‘policing’ role is not effective.
- S26 The importance of timely, consistent and comprehensive reports is emphasised in PFM reform literature, and efforts to improve consistency and comparability have been made through the introduction of international public sector standards. The academic debate on the advantages and disadvantages of accrual accounting (and budgeting) continues. OECD experience shows that the move from cash to accrual accounting needs careful planning, and to be part of wider public sector reforms.
- S27 Supreme Audit Institutions (SAIs) have a vital role in holding government to account and ensuring transparency in government operations. Generally, audit reforms take a long time, although a number of quick wins have been identified. Reviews suggest that audit reforms have benefited from peer-learning practices including twinning arrangements, contact committees and other regional affiliations.

### **Cross-cutting Issues**

- S28 First-generation PFM reforms in developing countries concentrated on technical issues, second-generation reforms have recognised the need to enhance the role of the legislature and thus improve domestic accountability. In developing countries, many donors have been promoting changes in legislation, but the literature notes that lack of compliance is often the major issue, and new legislation alone is unlikely to achieve desired results. The literature highlights a general lack of evaluations on the effectiveness of support provided to legislatures.
- S29 Generally, PFM reforms in OECD countries have taken place alongside broader public service reforms. OECD guidelines and results from several capacity building evaluations also highlight the links and dependencies between public service reforms and sustainable PFM reform.
- S30 Automated systems, particularly IFMIS have become synonymous with PFM reform, seen by some as even drivers of reform. Failure rates were reportedly high, because of unrealistic timescales, lack of ownership, insufficient consultation and inadequate specifications.
- S31 Gender responsive budget analysis (GRB) involves analyzing and reordering budgetary priorities from a gender perspective. The evidence from GRB initiatives is mixed, with concerns raised about the sustainability of initiatives where government ownership is weak. The role of civil society, and the value of tailored context specific inputs have been highlighted where a more equitable distribution of public resources has been achieved.

## **Moving Forward**

- S32 The new guidance for donors is to build on existing capacity rather than impose external solutions. There is also a realisation that money alone will not buy real reform. The literature highlights lack of professional skills, rather than managerial skills, as a serious constraint on PFM reform. Various training methods are used, but there appear to be no studies on which one is the most effective. However, peer groups and regional affiliations are becoming increasingly popular.
- S33 Recent reform literature emphasises the need to consider cross-cultural change management issues in the design and implementation of reforms. In Bangladesh and Guatemala, establishing ‘bottom-up’ support for reforms was critical to their progress; however, there appears to be limited evidence of the use of broader change management methods, such as managerial coaching. In the Pacific region, recognition of different cultural values has also been important in designing capacity-building programmes, but this appears to be a rather isolated example.
- S34 Recent literature emphasises the importance of civil society in all stages of the budget cycle and their role in promoting and monitoring PFM reform. The role of the media and private sector is also acknowledged, particularly in procurement reform and in the Extractive Industries Transparency Initiative (EITI); however, there do not appear to be many evaluations of their actual influence on PFM reform.
- S35 The trend towards greater use by donors of partner-country systems means that in aid-dependent countries, donors play a significant role in promoting PFM reform. The literature does highlight the need to understand the incentives of aid and the political economy of donors on PFM reforms, but no studies could be found on their impact.

## **Future Evaluation Topics**

- S36 The challenge of any reform is not the failures, but the ability to learn from the mistakes. Several of the most recent studies appear to have very similar messages to those finalised five or ten years ago, particularly on the need to proceed slowly. Evaluation of ‘first generation’ implementations of MTEF and IFMIS highlighted a number of critical success factors; however, no evaluation appears to have been carried out on whether lessons have been learnt.
- S37 A review of the literature highlights some potential research topics, such as variants on the Public Accounts Committee (PAC) model for the Caribbean (and Small Island Developing States (SIDS) generally), and the impact of tax administration issues on investment, doing business and state building. The Strengthened and Platform approaches are very new, and early evaluations are few or on-going, making it difficult to assign evaluation questions at this stage.

S38 This review of the available literature has also identified a number of knowledge gaps in ongoing reforms and/or interventions. A tentative list of possible evaluation topics and suggested questions has been developed, in consultation with the management committee.

- *PFM reform and service delivery* - Have the PFM reforms contributed to improved service delivery, through for example improved flow and predictability of funds at central government level? Have the PFM reform programme and any sector reform programmes (e.g. education, health) been mutually reinforcing or contradictory? Have PFM reforms resulted in greater predictability of fund flows and transparency for sub national (SN) bodies?
- *PFM reform and civil service reform* - How have PFM reforms taken into account the status of civil service reform initiatives in their design and implementation?
- *Procurement reform* - What outcomes have been achieved so far? Is the playing field more equitable?
- *Payroll reform* - Has the introduction of new automated systems resulted in better controls and better information for medium-term planning and budgeting purposes?
- *MTEF and IFMIS* - Have more recent implementations been guided by earlier evaluations or are the same mistakes still being made?
- *Legislative scrutiny* - Who has been the most effective in addressing legislative scrutiny issues, parliamentary networks, donors or other institutions? What techniques have proved the most effective; links with other jurisdictions, workshops, regional affiliations, visits?
- *Drivers of change approach* - How has this been used in practice, both in the design and implementation of reforms, and what effect has it had on success rates?
- *Change management* - Has this really received the required attention? To what extent have communication strategies been two-way, not just one-way? Have the techniques used been sensitive to cultural differences e.g. hierarchical nature of society, form of consultation, spoken not written?
- *Donor coordination and harmonisation* - Has there been consistency within individual country strategies, thus re-enforcing government PFM reform programmes or the reverse? Have organisational constraints e.g. separation of professional expertise (economists, accountants, procurement specialists) resulted in confusing messages for recipient governments?

- S39 In terms of prioritisation of evaluation topics, it may be helpful to assess impact on, or relevance to the following criteria: i) enhanced domestic accountability; ii) importance to the achievement of MDG; iii) potential to reduce scope for corrupt activities; iii) long-term sustainability of reforms; iv) potential use of country systems by donors; v) knowledge gap identified in the literature and vi) evaluation literature available.



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## **Abbreviations and Acronyms**

ADB	Asian Development Bank
AfDB	African Development Bank
AusAID	Australian Agency for International Development
BIS	Baseline Indicator System
BLI	Baseline Indicators
CABRI	Collaborative African Budget Reform Initiative
CCAGG	Concerned Citizens of Africa for Good Governance
CCPA	Canadian Centre for Policy Alternatives
CFAA	Country Financial Accountability Assessment
CIDA	Canadian International Development Agency
COFOG	Classification of the Functions of the Government
CPAR	Country Procurement Assessment Report
CPI	Corruption Perception Index
C/PI	Compliance/Performance Indicators
CPIA	Country Policy and Institutional Assessment
CSO	Civil Society Organisation
DAC	Development Assistance Committee
DeMPA	Debt Management Performance Assessment
DFID	Department for International Development
DoC	Drivers of Change
EC	European Commission
EFA	Economic and Financial Report
EITI	Extractive Industries Transparency Initiative
ESAAG	Eastern and Southern African Association of Accountant Generals
EU	European Union
EUSM	Expected Utility Stakeholder Model

GBS	General Budget Support
GEMAP	Governance and Economic Management Assistance Programme
GFS	Government Finance Statistics
GPFS	General Purpose Financial Statements
GRB	Gender Responsive Budget
GSDRC	Governance and Social Development Resource Centre
HIPC	Heavily Indebted Poor Country
IA	Internal Audit
IBP	International Budget Project
IDASA	Institute for Democracy in South Africa
IDS	Institute for Development Studies
IFAC	International Federation of Accountants
IFI	International Financial Institutions
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
INTOSAI	International Organisation of Supreme Audit Institutions
IPFA	Institute of Public Finance and Auditing
IPSAS	International Public Sector Accounting Standards
JBIC	Japan Bank of International Cooperation
LTU	Large Taxpayer Units
MDG	Millennium Development Goals
MKSS	Mazdoor Kisan Shakti Sangathan
MoF	Ministry of Finance
MTEF	Medium Term Expenditure Framework
NAO	National Audit Office
NDPB	Non-Departmental Public Bodies
NPFM	New Public Financial Management
NPM	New Public Management

ODA	Official Development Assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Cooperation and Development
PAC	Public Accounts Committee
PEFA	Public Expenditure and Financial Accountability
PEM	Public Expenditure Management
PEMPAL	Public Expenditure Management Peer Assisted Learning
PER	Public Expenditure Review
PETS	Poverty Expenditure Tracking Surveys
PFM	Public Financial Management
PFMRP	Public Financial Management Reform Programme
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Programmes
RA	Revenue Agency
ROSC	Report on the Observance of Standards and Codes
SAI	Supreme Audit Institution
SARA	Semi-Autonomous Revenue Authority
SARS	South African Revenue Service
SBS	Sector Budget Support
SEF	Sector Expenditure Frameworks
Sida	Swedish International Development Cooperation Agency
SIDS	Small Island Developing States
SIGMA	Support for Improvement in Governance and Management
SN	Sub National
SWAp	Sector Wide Approach
SWG	Sector Working Group
TI	Transparency International
TSA	Treasury Single Account

*Abbreviations and Acronyms*

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UN	United Nations
UNDP	United Nations Development Programme
VAT	Value Added Tax
WAEMU	West Africa Economic and Monetary Union

# 1. Introduction

## Purpose and Overall Objective

- 1.1 The purpose of this literature review, commissioned by the Department for International Development (DFID) on behalf of the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (Sida), the Canadian International Development Agency (CIDA) and the African Development Bank (AfDB) is three-fold. Firstly, to document the current public financial management (PFM) reform landscape, identifying the major underlying theories, significant trends and differences between approaches used in developed and developing countries. The second is to identify the main areas of reform under the major PFM components, and to document clearly what is known with respect to the effect of these reform processes, as well as to identify gaps in current knowledge. The final purpose of the literature review is, using the evidence base developed, to assist with the identification of potential evaluation topics and questions.
- 1.2 The overarching objective of the review is that it will serve as an input to a forthcoming evaluation of PFM reform processes. The terms of reference state that this evaluation will broadly cover: i) how PFM can be successfully strengthened in partner countries and ii) how donors<sup>1</sup> can effectively contribute to the successful strengthening of PFM in partner countries.
- 1.3 The World Bank has recently established a PFM reform database<sup>2</sup> that contains a collection of current reference material on PFM reforms. This information is drawn from a wide variety of sources within and outside the World Bank, and is designed to provide easy access to current knowledge on different aspects of PFM reform. However, work has not been undertaken recently to synthesise the literature, assessments and evaluations of the PFM reform processes initiated by actors (be they government or donor led).

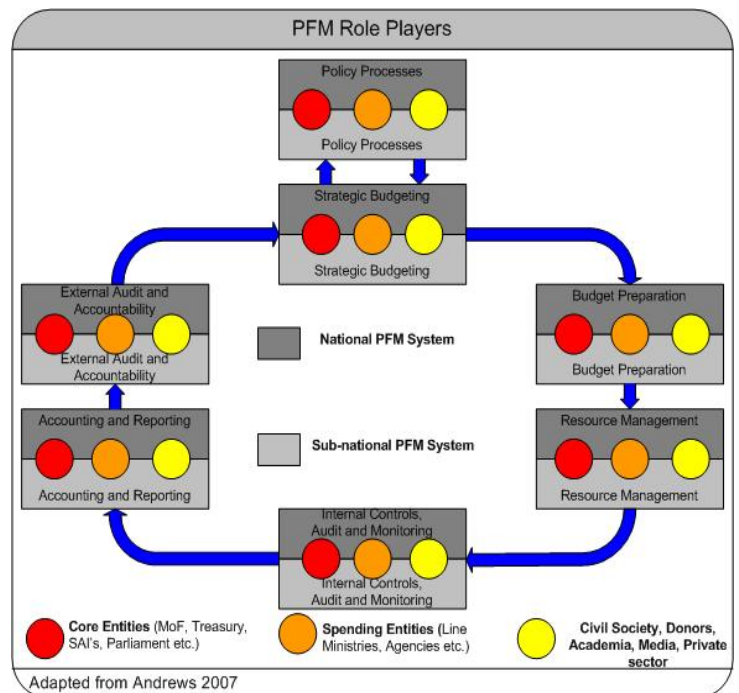
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<sup>1</sup> The term donors, rather than development partners, is used throughout this document, to avoid any confusion.

<sup>2</sup> This database falls amongst a myriad of PFM resources housed by other multilateral institutions (International Monetary Fund (IMF), AfDB, Organisation for Economic Cooperation and Development (OECD)), research institutions (Overseas Development Institute (ODI), Institute for Development Studies (IDS)), consortia of donors and academic institutions (Governance and Social Development Resource Centre (GSDRC)) and individual bilateral agencies (DFID, Sida).

## Defining PFM Reform

1.4 There is a consensus on generic stages of the budget cycle.<sup>3</sup> However, a review of the literature on PFM reform shows that there is no universally agreed definition of PFM. The narrowest definition confines PFM to the downstream activities of budget execution, control, accounting, reporting, monitoring and evaluation (Allen *et al* 2004). An alternative definition describes PFM as the taxing, spending and debt management of government, which influences resource allocation and income distribution. The spending portion covers the budget cycle, including budget preparation, internal controls, accounting, internal and external audit, procurement, and monitoring and reporting arrangements (Rosen 2002).



**Figure 1 The multiplicity of PFM role players and PFM relationships**

- 1.5 Witt and Müller (2006) include oversight and control as well as intergovernmental fiscal relations. The complexity of PFM relationships and multiplicity of PFM role players is best illustrated in *Figure 1* (Andrews 2007).
- 1.6 Reform means beneficial change. The Japan Bank of International Cooperation (JBIC) (JBIC 2001) sees PFM reform as a continuing process of improvement. An academic debate on the precise definition of PFM reform is not the purpose of this review. For the purposes of this paper, PFM reforms can be incremental or radical and involve institutional (regulatory and procedural) and organisational change.

## Scope of Review

1.7 Although recognising the interrelationship between the policy, management and oversight and control spheres of PFM, this paper adopts the middle road – taking the broader view of PFM described by Witt and Müller but not reviewing the literature on policy reform (e.g. tax policy).

<sup>3</sup> A budget cycle typically includes the following six stages: policy review; strategic planning; budget preparation; budget execution; accounting and monitoring; and reporting and auditing.



- 1.8 It provides an overview of the major theoretical models and approaches to PFM reform, and examines some of the reform experiences to date. Reform experience has guided the development of some of the newer approaches and continues to reinforce the need for recognition of country context; however, links between the theory and practice are often tenuous. It was not relevant therefore to frame the literature on reform experience within the models and approaches described.
- 1.9 Literature on critical issues of capacity development and country context is also reviewed; and the role of civil society and donors in PFM reform. Finally, the report assesses recent research on PFM reform from the sub-national and sector perspective.
- 1.10 The review focuses on literature, assessments and evaluations produced in the last ten years. The vast majority of the documentation reviewed is available publicly, although a few documents were provided to the consultants in draft format, ahead of their publication. The literature reviewed includes academic and technical articles, development practitioner guides, manuals, handbooks and websites.
- 1.11 Given that the overall objective of the review is to provide inputs to an evaluation on how to strengthen PFM in partner countries, the emphasis is placed on recent research into PFM reform in developing and transition countries. Actual experience in the implementation of reforms by OECD countries is often relevant, but frequently disregarded. Consequently, this literature review includes commentary on some of the most important findings and lessons from OECD countries.

## **Structure of Report**

- 1.12 The remainder of this chapter discusses the key drivers of recent PFM reform. The report is then divided into four further chapters. In chapter two, different approaches to reform of expenditure management and revenue administration are described. The New Public Management (NPM) Approach is briefly explained; and the chapter then traces the evolution of various approaches to expenditure management within the overall PFM reform process in developing countries. The final part examines different approaches to revenue administration, reviewing the literature on organisational changes in tax revenue administration. Chapter three discusses reform experience, and reviews the literature of the key system and procedural reforms taking place in the PFM subsystems e.g. budgeting, auditing, legislative scrutiny. Chapter four reviews the available literature on some of the other issues affecting PFM reform initiatives, such as country context, capacity, external stakeholders and links with service delivery and other public service reforms. The final chapter summarises the key themes and issues and highlights gaps in knowledge. Topics for future evaluation and a tentative list of evaluation questions, developed in consultation with the management committee, is provided. There was insufficient evidence from the literature review to enable a conclusive list of topics to be developed, and the list should therefore be viewed as tentative and the basis for future discussion.

1.13 References are listed by chapter and additional texts are provided in the general reading list. The report also contains two annexes: Annex 1 provides a glossary of common terms; Annex 2 contains a summary of assessments used to monitor PFM reform and assess the status of PFM systems.

## **Drivers of PFM Reforms**

1.14 What has triggered reforms? There is no single answer and the attribution of cause and effect would be hard to prove. However, there is a consensus that in some countries, the following circumstances have provided the impetus for (or facilitated) change.

- Fiscal crisis (e.g. Tanzania, UK, Canada, Argentina, Asian economies)
- Political change (e.g. South Africa, former Soviet Union countries)
- Changes in public expectations /public pressure (e.g. UK, Canada, Columbia, Guatemala)
- Post conflict (e.g. Rwanda, Burundi, Mozambique, Afghanistan, Liberia, Timor Leste)
- New technology (e.g. E-procurement systems in Chile, Mexico, Korea and Philippines)
- Regional requirements (e.g. West Africa Economic and Monetary Union (WAEMU), European Union (EU) accession)
- Donor pressures (e.g. Heavily Indebted Poor Countries (HIPC) initiative and other donor demands (Vani and Dorotinsky 2008))

1.15 PFM reforms in Central and Eastern European countries wishing to join the European Union (EU) were propelled by the need to meet the requirements of EU *acquis communautaire*<sup>4</sup>, particularly in the areas of internal controls, internal audit and external audit.

## **Evolution of Support to PFM Reform**

1.16 In general, PFM reform has been a long-term process that does not work to five-year timeframe. New Zealand adopted a radical (big bang) approach to its reforms. In contrast, public sector and PFM reform in most OECD countries followed a

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<sup>4</sup> The entire body of European laws is known as the *acquis communautaire*. This includes all the treaties, regulations and directives passed by the European institutions as well as judgements laid down by the Court of Justice. The term is most often used in connection with preparations by candidate countries to join the union as they must adopt, implement and enforce all the *acquis* to be allowed to join the EU.

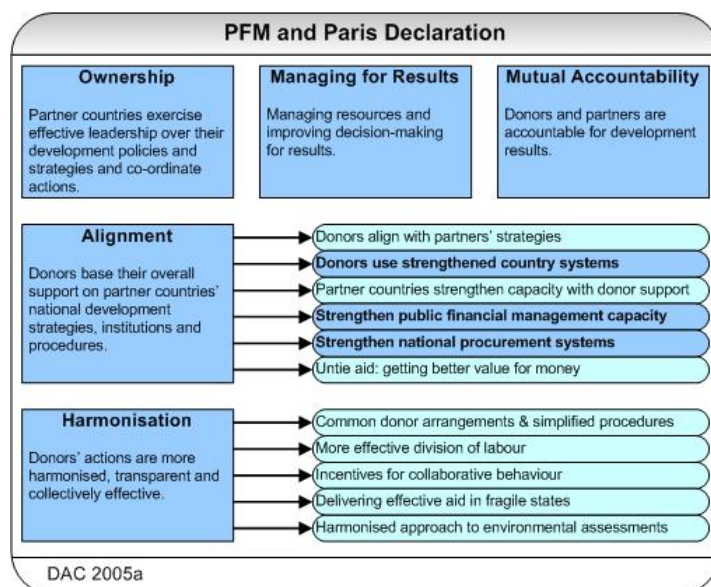
comparatively slow and steady path, with sporadic bursts of speed. Even in a developed country, such as the US, accounting and budget execution reforms have taken a long time to introduce and an even longer time to achieve the desired results (Wescott 2008).

1.17 In developing countries, donors have been providing some assistance on PFM issues since the mid-fifties. However, it was only in the late eighties that there was a real recognition by donors that to achieve economic growth, improvements in public sector management needed to accompany technical investments (Wescott 2008).

1.18 Throughout the nineties, the majority of assistance was provided by donors to developing countries through isolated projects, and frequently included complex interventions such as medium-term expenditure frameworks (MTEF), performance budgeting, gender budgeting and integrated financial management information systems (IFMIS) (Vani and Dorotinsky 2008).

1.19 In the last ten years, the recognition of aid fungibility<sup>5</sup>, greater acknowledgement of the negative effects of corruption and an increase in policy-based lending all led to an increased emphasis on governance issues including open and orderly PFM systems. In 2005, government and donor commitment to improved PFM systems (and use thereof) was formalised in the Paris Declaration (*Figure 2*). Under the declaration, targets<sup>6</sup> were established for improvements in PFM and in procurement.

1.20 The Monterrey Conference also specifically called on development cooperation agencies to intensify their efforts to: “Harmonise their operational procedures<sup>7</sup> at the highest standard so as to reduce transaction costs and make ODA<sup>8</sup> disbursement and delivery more flexible, taking into account national development needs and objectives under the ownership of the recipient country” (OECD 2003:3).



**Figure 2 PFM and Paris Declaration (2005)**

<sup>5</sup> The concept of fungibility relates to the fact that funds are potentially exchangeable.

<sup>6</sup> See Annex 2 for more discussion on the specific progress indicators.

<sup>7</sup> UN Harmonised Approach to Cash Transfers would be one example, where this has been done.

<sup>8</sup> Official Development Assistance.

- 1.21 Donors are now replacing fragmented and partial project based support with joint (pooled) funding support to comprehensive reform programmes with joint (pooled) funding support, PFM reform programmes<sup>9</sup>.
- 1.22 In terms of donor agencies providing General Budget or Sector Budget Support (GBS/SBS) (be they multi-laterals or bi-laterals), one of the key factors that determines their willingness to provide this form of funding is whether the partner country has a credible and relevant PFM reform programme in place or under construction.
- 1.23 Although corruption is not a new phenomena or one that is region specific, the relationship between sound and orderly PFM systems and reduced levels of corruption is also receiving increased attention. Mapping freedom from corruption (using Transparency International's (TI) Corruption Perception Index (CPI)), against the quality of PFM (using the World Bank's Country Policy and Institutional Assessment (CPIA)), suggests that higher quality PFM systems correlate with lower perceptions of corruption (Dorotinsky and Pradhan 2007). Heilbrunn (2004) argues that the creation of anti-corruption commissions is a token effort that lacks substance, if reforms in PFM do not take place.
- 1.24 In response to these issues, donors now provide significant levels of support to PFM reform. Allen and Last (2007) report that worldwide, 50 different donors are providing PFM support, with on average, seven working in each country. For the World Bank alone, the number of projects with PFM components of 25% or more of the total project cost increased from 110 over the period 1987-99, to 202 over the period 2000-2006 (Wescott 2008).

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<sup>9</sup> In the Authors' experience, coordination with other reform programmes is sometimes weak.

## **2. Theoretical Models and Approaches to PFM Reform**

### **Expenditure Management ‘Models’ and Approaches**

- 2.1 During the seventies and eighties, OECD countries and some developing countries started to review the management of their public sector. This led to the development and implementation of the NPM model. By the mid nineties, academics and practitioners realised that the transferability of these ideas to developing countries was beset with problems, and the need for developing countries to ‘get the basics right’ before embarking on more complex initiatives was realised (Schick 1998c). During the same period, the World Bank also reviewed its own approach to providing assistance to budget reforms and developed the Public Expenditure Management (PEM) Approach.
- 2.2 By the beginning of 2000, both developing country governments and donors began to question why PFM and public sector management interventions to improve expenditure management had only achieved limited success. The ensuing search for answers led to the development of methods to: improve country ownership; establish a more realistic pace of change; enhance donor harmonisation and recognise the importance of political context.
- 2.3 The structure of this chapter mirrors this history of expenditure management, before going on to discuss revenue management. Each section provides a brief outline of the approach and its impact. The approaches covered include: the NPM model; the PEM Approach; Getting the Basics Right; the Platform Approach; the Strengthened Approach to PFM reform; the Drivers of Change (DoC) Approach and the Expected Utility Stakeholder Model (EUSM). The last three have been included under expenditure, as they are more usually associated with expenditure management, although they could be applicable to other situations. More popular approaches to the reform of tax revenue administration<sup>10</sup> are described at the end of the chapter.

### **New Public (Financial) Management (NPFM)**

- 2.4 NPM introduced not just a different way of managing public services, but also the need for different financial management tools and techniques.. Introduced initially in response to widespread public criticism of the public service, the overall ethos of the reforms is greater public sector efficiency and, as Manning (2001) explains, has two key tenets: allowing managers to manage and making managers accountable.

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<sup>10</sup> Rosen (2002) includes taxing, and Andrews (2007) includes resource management in their PFM definitions. The Authors consider that tax revenue administration is a fundamental element of PFM, although recognising that in practice it has often been treated separately.

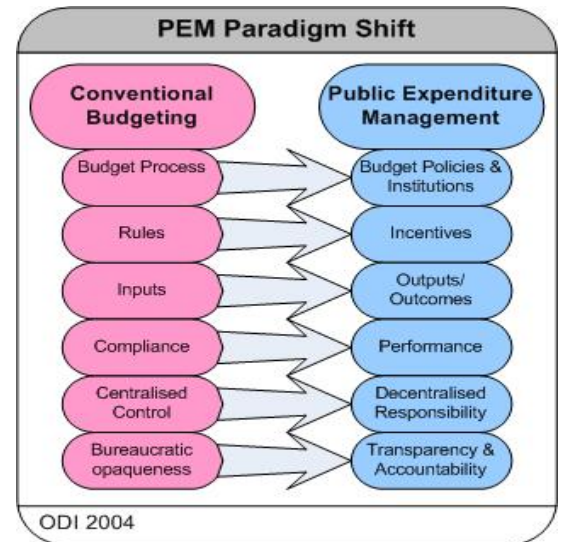
- 2.5 Common objectives of NPM include: i) a management culture and orientation that is customer and results focused; ii) structural or organisational alternatives that promote decentralised authority and control; and iii) the separation of policy making from service delivery. There are also implicit expectations of greater operational efficiency and bureaucratic responsiveness to political principals. However, in its implementation, there are multiple choices rather than a single answer. Consequently, the introduction of NPM has not followed a common path. New Zealand is regarded as at the forefront of these reforms, but Schick (1998b) notes that few other countries have adopted the total mantra. Iceland and Singapore adopted selected features of the New Zealand system, but many only embrace the managerial ethic. Many African countries influenced by donors have also adopted some NPM type reforms, although in most cases with little real progress (ECA 2003).
- 2.6 The financial management measures associated with the introduction of the NPM model are often referred to as NPFM, a term that can also not be explained by a single definition or application. Indeed Olson *et al* (1998) describe it more as a reforming spirit aimed at increasing financial awareness in public sector decision-making and therefore an integral part of the broader public service reforms. Guthrie *et al* (2005) identify five key dimensions to NPFM: i) changes to financial reporting systems (cash to accrual); ii) devolution of budgets; iii) market based costing and pricing systems; iv) a performance measurement approach and v) performance based (internal and external) auditing. Literature on some of these 'tools and techniques' is discussed in the following chapter.
- 2.7 In terms of the progress and impact of the overall NPFM reform process, Olson *et al* (2001) notes that several authors have questioned the adequacy of the reform evaluations. This is somewhat ironic, given the emphasis on performance evaluation in NPFM itself. In a move to remedy this, the OECD's 'Government at a Glance' publication is being developed to help governments monitor the progress of their reform agendas (Lonti and Woods 2008).
- 2.8 What is clear from available literature on NPFM reforms in OECD countries is that social, political and organisational issues affect public sector accounting and management, and influence the direction and speed of reforms. How things have progressed in Northern Europe is different from Southern Europe, in Sweden from the United States (Guthrie *et al* 2005). Newberry and Pallot (2005) conclude that while there has clearly been progress, initial expectations have not been met and some concerns have been raised about the increasing complexity of the financial management systems, actually reducing rather than enhancing political accountability and control.

## **Public Expenditure Management Approach (PEM)**

- 2.9 The World Bank's work in public expenditure management evolved from an emphasis on investment efficiency in the eighties to a wider recognition of institutions and governance building. Developed in the late nineties and described then as the contemporary approach to budgeting, the PEM Approach is more a way of viewing public expenditure management. It stresses the need to understand

the rules of the game that govern budget formulation and execution, and the way that institutions influence choice and the achievement of government's objectives (Schick 1998a).

2.10 As illustrated in *Figure 3* the focus shifted from the 'due process approach' of conventional budgeting to a broader arena, which highlights the importance of the complex web of actors and institutions involved in the budget process, and of linking expenditure with measurable results in terms of outputs and outcomes. In particular, the PEM Approach focuses on incentives and the informal practices and behaviour of budgeting. Advocates of the approach emphasise that improvements in public expenditure management require changes in budgetary institutions, the roles of spenders and controllers, the rules under which they claim, allocate and use resources and the information available to them (Schick 1998a). No evaluations of the impact of the PEM Approach on reform implementation could be found.



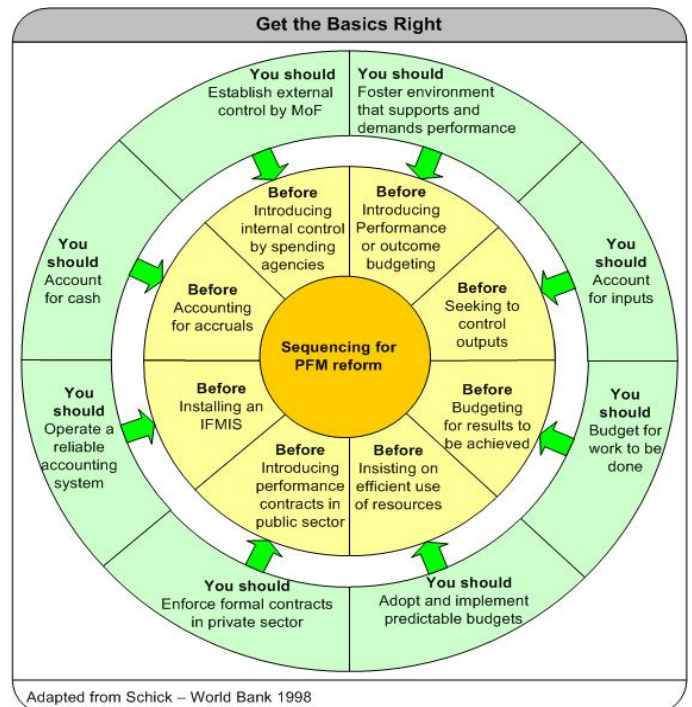
**Figure 3 The PEM Paradigm Shift**

### Getting the Basics Right

2.11 This philosophy appears simple: focus on the basics on which reform is built, not on particular techniques. Schick argues that the lesson for developing countries from some of the radical reforms of OECD countries is to 'get the basics right' (World Bank 1998). *Figure 4* illustrates the issues that he considers important when sequencing reforms.

2.12 In terms of budgetary outcomes, the argument is also that a government needs a realistic sustainable budget (aggregate fiscal discipline) before it can achieve the other objectives of allocative efficiency (doing the right things not merely doing things right) and operational efficiency (Schick 1998a). In response to fiscal crisis, developing countries were encouraged to centralise controls e.g. Tanzania in the mid nineties. It is interesting to note that in contrast, some developed countries adopted the NPM Approach and decentralised operations.

2.13 The World Bank (1998) notes that budget reform cannot always be so neatly sequenced, but still urges



**Figure 4 Getting the Basics Right**

reformers to be opportunistic and use performance problems to drive a demand for ‘getting the basics right’. An alternative argument made by Andrews (2006), is that the emphasis on controls associated with this approach, hinders deeper PFM reform.

2.14 In practice, Wescott (2008) cites several instances of where the World Bank has successfully applied the ‘basics first’ philosophy e.g. Bulgaria and Guatemala. He also provides examples of countries where the World Bank did not adopt this approach, instead supporting complex initiatives e.g. accrual accounting in countries such as Jamaica and Paraguay, which were not ready for such sophisticated tools. As Stevens (2004) notes, the problem seems to be that government officials and donors do not have a shared understanding of the term ‘basics’. He asserts that this has led to the implementation of advanced solutions, which have often proved ineffective and inappropriate.

## The Platform Approach

2.15 A study to review measures used by donors to address weaknesses in PFM systems when providing policy-based lending, laid the foundations for the Platform Approach (Brooke 2003). In some ways, it is similar to ‘getting the basics right’ although it takes a more holistic approach to the PFM reform process. It aims to implement a package of measures or activities designed to achieve increasing levels (‘platforms’) of competence over a manageable timeframe (DFID 2005c). The focus of each platform is on an intended outcome (e.g. a credible annual budget) rather than the achievement of a particular output or activity (e.g. production of a budget manual).

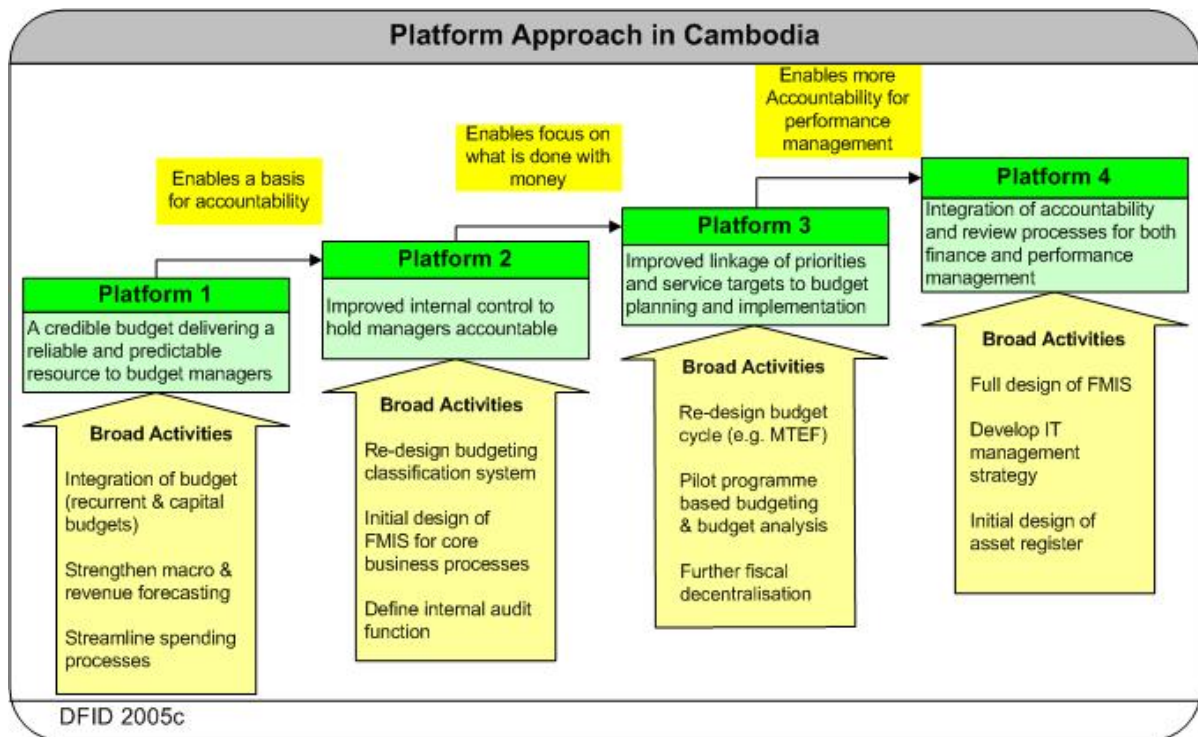


Figure 5 Platform Approach in Cambodia



- 2.16 The initial activity is for the government to define its overall vision for public financial management and accountability. As shown in *Figure 5*, platforms are then defined to achieve this vision. Country context is seen as critical. In Cambodia, the first of four platforms designed to meet the government's long-term vision for PFM was to have a credible budget delivering predictable resources. In Russia, with the basic systems in place, the delegation of financial powers to budget holders and the introduction of results-based management were seen as essential first steps (Olander 2007).
- 2.17 The hypothesis behind the Platform Approach is that it can help facilitate genuine government leadership, a politically acceptable pace of change, donor harmonisation and greater levels of trust. These were all problems, identified as the main reasons for lack of progress on PFM reforms (DFID 2005c). Once the platforms are defined, the approach then proposes a series of iterative steps to develop the action plan for that particular platform, including initial activities required for subsequent platforms.
- 2.18 A number of countries, including Cambodia, Uganda, Kyrgyzstan, Kenya, India (Orissa State) and Russia have used the Platform Approach. In all cases, the reforms are at their early stages. Initial lessons from the Cambodian example suggested that for the process to be successful, it is necessary for donors to allow the government to lead, to be realistic with timescales, to be open and honest and to be prepared to drop inappropriate projects (DFID 2005c).
- 2.19 At the 'end' of Platform One in Cambodia, a number of positive and tangible benefits were identified. These are reported to include: i) the amount of customs revenue collected through the banking system increasing from zero in 2004 to nearly one third in 2006; and ii) the stock of old expenditure arrears being reduced by over 40% (OECD 2008b). A recent presentation on the sequencing issues in the Cambodian reform process also identified a number of critical success factors including: i) the importance of extensive and time-consuming consultation within government (at a managerial and technical level); ii) the importance of ensuring donor unity through lengthy consultation processes; and iii) the need to restrain donor demands (Taliercio 2008).

## **Strengthened Approach to PFM Reform**

- 2.20 Responding to the need to improve PFM systems as a critical element for economic growth and development, several institutions came together in 2001 to form the Public Expenditure and Financial Accountability (PEFA) initiative<sup>11</sup>.

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<sup>11</sup> A multi-donor effort composed of the European Commission, the UK's Department for International Development, the Swiss State Secretariat for Economic Affairs, the French Ministry of Foreign Affairs, the Royal Norwegian Ministry of Foreign Affairs, the World Bank, the International Monetary Fund and the Strategic Partnership with Africa. See Annex 2 for more details of the indicator set.

2.21 In 2003, the PEFA programme commissioned a study to help develop a more coordinated and effective way of assessing and reforming PFM in developing countries, particularly those receiving significant external assistance (Allen *et al* 2004). They identified three problem areas. The first was the focus on diagnostics, to the extent that countries were being over-diagnosed. The report highlighted the vast array of diagnostics being carried out, the extent of duplication, the different purposes (e.g. developmental or fiduciary risk), the gaps and perhaps most importantly, the inability to objectively measure any progress. Only the Heavily Indebted Poor Country (HIPC) assessments had any performance-based measurements. Annex 2 provides an updated list of current diagnostics used to both monitor PFM reform and to make baseline assessments of PFM systems. A second 'barrier' was the lack of country ownership, reflected by a multitude of externally driven action plans. Finally, the third obstacle was the plethora of PFM reform projects, often uncoordinated, sometimes competing, and frequently over-taxing government officials charged with their implementation.

2.22 The various lessons from this study were distilled into the 'Strengthened Approach to Public Financial Management Reform', with three pillars of good practice in PFM. These are: i) a country-led agenda, with a country-led PFM reform strategy and action plan; ii) a coordinated programme of support (where needed), with a coordinated International Financial Institutions (IFI)-donor multi-year programme of PFM work, that supports and is aligned with the government's PFM strategy; and iii) a shared information pool, with a framework for measuring results that provides consistent information on country PFM performance, including progress over time. The new relationship is illustrated in *Figure 6* and the approach is now embedded in the 2005 Paris Declaration for Aid Effectiveness and OECD Development Assistance Committee (DAC) Guidelines on Capacity Building in PFM.



**Figure 6 The PFM Strengthened Approach**

2.23 Betley (2008) recently completed a report on the impact of the Strengthened Management Approach. Based on the 12 countries reviewed, she found that: i) PEFA assessments have made an impact on both governments and donors; ii) there have been cases where the PEFA assessments have led to a direct change in governments' PFM reform programmes and iii) in many cases, they have provided stakeholders with a comprehensive and evidence-based view of PFM strengths and weaknesses, as well as achievements and challenges.

## Political Economy ‘Models’

- 2.24 Marquette and Scott (2005) argue that until the eighties, the politics of development was an integral part of development discourse; however, for both disciplinary and institutional reasons the study of development became dominated by economics. At the beginning of the twenty-first century, in response to the increasingly complex and highly political nature of their work, DFID, the World Bank and Sida developed ‘models’ for political analysis<sup>12</sup>.
- 2.25 The approaches discussed in the preceding sections look at the implementation of PFM reforms. Political Economy ‘models’ provide a framework to study the political context in which any type of civil service, sector or PFM reform takes place. According to Bjuremalm (2006), Sida’s power analysis studies tend to gravitate towards a focus on the links between human rights, democracy and poverty reduction, formal versus informal institutions, agents and the importance of process. No examples of the use of these studies for PFM reform were found in the literature, whereas, DFID’s Drivers of Change (DoC) approach and the World Bank’s Expected Utility Stakeholder Model (EUSM) have been used in relation to PFM reform and are discussed in more detail in the following sub-sections.

### *The Drivers of Change (DoC) Approach*

- 2.26 DFID’s DoC approach emphasises the importance of political analysis to understanding what is likely to bring about positive change. The approach evolved from three studies commissioned by DFID in 2004, examining the political economy of the budget process in Ghana (Killick 2005), Malawi (Rakner *et al* 2004) and Mozambique (Hodges and Tibana 2004).
- 2.27 Their main conclusions were firstly that the budget is a political process rather than just a technical one, and secondly that there is a gap between formal institutions (how things are supposed to work) and informal practices (how things actually work) (DFID 2007b). Schick (1998c) also notes that in poorer countries, informal practices often ‘make the system work’ but can retard development and breed corruption. Rakner *et al* (2004) describe the budget process as a ‘theatre’ that masks the actual distribution of resources and spending patterns. Killick (2005) concludes that this undermining of formal institutions leads to large deviations between budget estimates and actual spending, strong systematic biases and large leakages between the centre and the frontline. It was found that this state of affairs was generally tolerated in all three countries. The reasons given were that: i) accountability institutions were not effective (lack of capacity, time constraints, lack of political will, ineffective parliamentary scrutiny); ii) there was an inadequate flow of information (culture of secrecy among officials, lack of timely reporting); iii) low public awareness (under-developed civil society including independent media); and iv) donor conditionalities (budget ‘ritual’ maintained to keep the donors happy).

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<sup>12</sup> A guidance note on the use of both the DoC approach and Power Analysis has been prepared by the OECD DAC network on governance with the intention of improving and sharing the outcomes.

- 2.28 The studies propose that PFM reform will only succeed if there is political will to drive the reforms, sufficient capacity for long-term sustainability, strengthened parliamentary systems, and a civil society to hold the government accountable. In the absence of this strong political leadership, Hedger and Kizilbash Agha (2007) suggest that politically astute technocrats could take centre stage in the reform process<sup>13</sup>.
- 2.29 DFID has now carried out a number of DoC studies in various countries. However, at present it is not possible to verify whether these high-level analyses have been translated into operational strategies and programmes. Marquette and Scott (2005) acknowledge the usefulness of DoC analysis, but question its practical application in reform planning. A review of some of DFID's latest country evaluations indicates that in some cases the DoC approach has been used to identify potential entry points e.g. in the Kenya Revenue Authority, but the extent of its use and how it has influenced both the design and implementation of interventions is unclear.

### ***Expected Utility Stakeholder Model (EUSM)***

- 2.30 The other main Political Economy model has been piloted by the World Bank's East Asia and Pacific Region and has "sought to elevate the sophistication, accuracy, and operational relevance of its political analysis by piloting a game-theoretic approach to analyze public sector governance reform issues in two of its client countries" (Nunberg and Green 2004: 1). The model has also been used to determine potential responses to tax administration reform. Marquette and Scott (2005) do question whether such an economics-based methodology can be applied, effectively or reliably.

## **Revenue 'Models' and Approaches**

- 2.31 Tax revenue reform has been widely influenced by four main theoretical approaches. These are: i) the Public Economics Approach, which emphasises the (micro-economic) efficiency and equity of taxation systems; ii) the Macro-Economic Approach, which emphasises the impact of taxation on economic aggregates e.g. distribution of household income, levels of savings, level of inflation and public debt; iii) the Administrative Approach, which emphasises effectiveness and efficiency in terms of the administrative cost of collecting tax and the cost of compliance and iv) the Political Approach, which recognises the inherent political nature of the taxation process and the various preferences and incentives in existence (Lledo *et al* 2004). The scope of this review excludes policy related literature. The following paragraphs therefore focus only on two of the main administration 'models'.

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<sup>13</sup> This does seem to assume that the technocrats are not political appointees themselves.

- 2.32 The first approach re-aligns organisational activities on a functional basis e.g. collection, education and audit services, rather than on a tax basis e.g. Value Added Tax (VAT) and Income Tax. As part of this shift, a number of revenue bodies have also created large taxpayer units (LTUs) to concentrate limited resources on dealing with all aspects of large taxpayer compliance. The advantages of such an approach are considered to be: i) strengthened accountability; ii) risk-based allocation of resources and iii) better matching of enforcement, service, and educational programmes to specific types of taxpayers (Crandall and Bodin 2005). Consequently, multi-lateral and bi-lateral donors seeking greater efficiency and ways to minimise corruption have promoted many of these changes, in developing and middle-income countries.
- 2.33 The second approach that gathered pace in the early nineties, involves the establishment of Semi-Autonomous Revenue Agencies (SARAs). Some are in developed countries, but most of the almost forty, are in Latin America and Africa. According to Kidd and Crandall (2006), there is no standard governance ‘model’, but they all have some form of independence from standard public service policies. However, they note that the degree of autonomy varies, with the US having comparatively low levels and Kenya and Peru having relatively high levels. The driving forces behind their creation were low levels of collection, widespread perception of corruption and pressure from international aid agencies. There are various arguments for and against this ‘model’. Claimed advantages include greater operational autonomy and freedom from political interference. Some potential problems include the adoption of an enclave approach, negative impact on morale of other government departments and the inherent conflict between the SARA and the MoF (Taliercio 2004, Mann 2004).
- 2.34 Findings on the effectiveness of SARAs are mixed. Kidd and Crandall (2006) argue that performance attribution is very difficult. Based on a review of several DFID projects, Delay *et al* (1999) argue that SARAs have much to offer, but are not a panacea for all ills, do not prevent political interference and are no guarantee against incompetence and malpractice. Gray and Chapman (2001) also note that the framework has not increased enforcement levels. Based on a desk-based study of existing SARAs, Kidd and Crandall (2006) also conclude that their creation has been intuitive, based on pressure from IFIs and neighbouring country practices, rather than on any tangible evidence of success.

## Summary

- 2.35 *The NPM Approach:* In OECD countries, historical, political and social differences have influenced the direction and speed of NPM and NPFM type reforms. Although the literature acknowledges progress in reforming financial management, whether it has resulted in improved accountability or service delivery is questioned.
- 2.36 *The PEM Approach:* This approach or viewpoint focuses on incentives and the informal practices and behaviour of budgeting, moving away from an earlier focus on rules and process.

- 2.37 *Getting the Basics Right*: Although intellectually rational, the ‘getting the basics right’ philosophy advocated for developing countries, seems to have been hindered by the lack of any common agreement between recipient governments and donors (and between donors), on what is meant by basics.
- 2.38 *The DoC, Platform and Strengthened Approaches*: These various reform approaches have evolved over time, frequently in response to obstacles and limited progress of earlier reforms in developing countries. In practice, current PFM reform programmes are likely to contain elements of more than one approach<sup>14</sup>. Both the Platform and Strengthened approaches are comparatively new, and consequently few progress assessments or substantive evaluations have been conducted. However, initial studies show some positive impact and tangible benefits. DFID has now carried out a number of DoC studies in various countries. At present, it does not appear possible to verify whether these high-level analyses have been translated into operational strategies and programmes.
- 2.39 *Organisational changes in tax revenue administration*: The most popular ‘model’ for revenue administration, particularly in Africa and Latin America, has been the introduction of SARAs. Claims are made about their positive impact; however, attributing increases in revenue collections solely on a new governance framework is difficult, and their introduction alone, does not prevent political interference or fraudulent activities. Another trend in revenue administration has been to organise activities by function e.g. audit services, collections, rather than by tax type e.g. VAT or Income Tax, in the belief that this increases collections and reduces the potential for corruption.

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<sup>14</sup> Authors’ own experience.

### **3. PFM Reform – Changing the ‘Rules of the Game’**

#### **Introduction**

- 3.1 The theoretical ‘models’ described above reflect different approaches within development theory. Each approach is ideologically separate and based in social and political theory, which gives more or less weight to factors such as the role of political actors, context, informal systems and processes, country ownership and technical inputs. Each aims for a similar outcome ie. to develop more effective, efficient and accountable PFM systems, but they differ in terms of process, and the emphasis placed on different aspects of PFM reform.
- 3.2 This chapter looks in more depth at reform experience; and the literature on the legislative, systems and procedural changes that have taken place. As described above, reform experience has guided the development of some of the newer approaches and continues to reinforce the need for recognition of country context. Direct links between theory and practice are tenuous.
- 3.3 PEFA (2005) identifies the critical dimensions of an open and orderly PFM system. They are: i) budget comprehensiveness and transparency; ii) policy based budgeting; iii) predictability and control in budget execution; iv) accounting and reporting and v) external scrutiny and audit. The introduction of sound systems and procedures in these areas should lead to dimension vi) budget credibility. This chapter is structured around some of the key reforms taking place in these five dimensions; however, as Witt and Müller (2006: 30) emphasise, it is important to remember that “public finance comprises a complex set of closely interrelated subsystems (e.g. tax and customs, budgets, expenditure, inter-governmental finance, parliamentary oversight, internal and external financial control). Reforming a particular subsystem may have consequences for a number of related areas”.
- 3.4 The following section discusses the current difficulties of assessing progress and evaluating the impact of PFM reforms. The final section reviews the PFM reform literature on crosscutting issues such as legislation, automated systems and gender budgeting, which transcend all of the five dimensions.

#### **Progress Assessment and Impact Evaluation**

- 3.5 In the past, many diagnostic reviews of PFM including Country Financial Accountability Assessments (CFAA)<sup>15</sup>, Country Procurement Assessment Reports (CPAR) and Reports on the Observance of Standards and Codes (ROSC) – Fiscal Transparency, were not designed to assess the progress of reforms. Only the 2001 and 2004 HIPC assessments used a scoring system, and therefore could provide an

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<sup>15</sup> See also Annex 2 for further discussion.

objective view of progress. The PFM performance measurement framework (commonly known as the PEFA framework), launched in June 2005, has a clearly defined and calibrated scoring system and enables comparison over time; however, to date, most countries have only carried out one assessment<sup>16</sup>. The more detailed monitoring frameworks for debt management, procurement and tax administration have also only recently been introduced.

- 3.6 Without baseline data and benchmarks, many reported successes and improvements have proved difficult to verify. In 2007, a desk-based study for the World Bank<sup>17</sup> found that many reform ‘success’ stories had only achieved output stage e.g. ‘budget procedures manual issued’, rather than any discernible outcomes e.g. ‘predictability of medium term allocations to line ministries’. Sustainability of some of the more successful initiatives was also problematic.
- 3.7 Based on the 2001 and 2004 HIPC assessments, the IMF and World Bank (2005) report showed that actual progress varied across countries and indicators. The total number of benchmarks met by the entire sample of 23 HIPC countries increased by 10 percent—from 137 to 150—while the average number of benchmarks met per country increased marginally. For the period 2001–2006, a report by De Renzio and Dorotinsky (2007) linked 11 of the 16 HIPC indicators to PEFA scores for 15 heavily indebted countries. Amidst, numerous caveats, they conclude that there has been limited and uneven progress among the countries, although “some countries (e.g. Burkina Faso, Ghana, Guyana, Tanzania, and Zambia) made more progress than others (e.g. Mali, Benin, and São Tomé and Príncipe)” (OECD 2008b:18). According to Dorotinsky (2008), lessons from these tracking studies include: i) the need for realistic timescales; ii) connections between various PFM system components are understood in theory, but frequently ignored in practice; and iii) customized reforms may yield better results, than donor’s prepackaged measures. In another study, the World Bank (2008) reviewed the public sector reforms it supported, and concluded that two thirds of all its PFM related projects showed an improvement in performance; however, this conclusion is based on only one indicator of the Bank’s CPIA and the review of a relatively small number of case studies.
- 3.8 Many impact and outcome evaluations of PFM reforms are not based explicitly on OECD evaluation criteria (relevance, effectiveness, efficiency, impact and sustainability).<sup>18</sup> Consequently, many findings and conclusions are based on observations and experience rather than objective data. This does not imply that positive outcomes have not been achieved, but rather that subsequent independent verification is difficult. Many donor-funded evaluations of PFM reforms have been of their technical assistance, rather than the relevance, impact or sustainability of the reform itself.

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<sup>16</sup> It is recommended that assessments are carried out once every three years.

<sup>17</sup> The study was carried out by C Pretorius, in conjunction with the World Bank’s financial management team, as an initial input to their FM Solution series: <http://go.worldbank.org/YB2TEIMSW0>.

<sup>18</sup> Many donors including DFID, AfDB and AusAID use OECD criteria in the evaluation of their assistance. Evaluations of the actual specific tool or technique itself e.g. the introduction of accrual accounting, are not measured so rigorously.



## Budget Comprehensiveness and Transparency

### *Budget Classification*

- 3.9 The Government Finance Statistics (GFS) manual (IMF 2001) and the UN Classification of the Functions of Government (COFOG) provide guidance on the classification of government’s revenues, expenditures and functions. Conformity with these classifications facilitates the preparation of statistical reports and the macroeconomic analysis of fiscal data. Programme classification as the basis for programme budgeting is also used in many OECD countries and developing countries. Here, in contrast to economic and functional classifications, there is no guidance on its construction. Consequently, there are numerous variations, although many now restrict the scope of a programme to a single administrative unit e.g. Ministry of Health rather than a programme, which is multi-institutional and for which there is therefore no clear line of responsibility (Diamond 2003b).
- 3.10 In heavily indebted countries, reform of budget classification has shown major improvements (De Renzio and Dorotinsky 2007). Improving the information base for budget reporting and budget management purposes has been a core part of the South African Public Financial Management Reform Programme (PFMRP). Success is attributed to a number of factors including: i) phased implementation approach; ii) comprehensive communication and training strategy and iii) close monitoring of implementation and compliance. However, the main reason given for the successful implementation of the new budget classification system is that it is part of an overall strategy to make public finances more accountable, transparent and better targeted (CABRI 2005).
- 3.11 There seems to be no evidence that improvements in budget classification, to meet international standards, have also led to improvements in budget reporting for either management or public use. Indeed, results from the International Budget Project (IBP) open budget questionnaire show that the weakest scores in terms of public accessibility to budget information relate to the fact that most governments fail to provide user-friendly information to the public and the legislature (Gomez *et al* 2004).

## Policy-Based Budgeting

### *Medium-Term Expenditure Frameworks (MTEFs)*

- 3.12 A government budget (approved spending) should reflect what it says it will do (government policies). A medium-term perspective is crucial for improving links between policy, planning and budgeting (Holmes and Evans 2003, World Bank 1998). According to Holmes and Evans (2003: 5), “the appeal of MTEFs lies in their potential to link the often competing short-term imperatives of macroeconomic stabilization with the medium and longer-term demands on the budget to contribute to improved policy making and planning, and to the efficiency and effectiveness of service delivery”. As an integral part of the annual

budget process, World Bank (1998: 48) describes an MTEF as consisting of “a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources”.

- 3.13 In practice, Brumby (2008) states that a working MTEF requires: i) creation of macro-economic and fiscal envelopes; ii) determination and articulation of high level policies (reallocation between sectors); iii) bidding by departments in the context of agreed amounts (reallocation within sectors); iv) iterative bidding processes; and finally v) achievement of a credible budget reconciling policy and available resources. By implication, he notes that this requires a significant amount of capacity, including adequate data and skills, an ability to set priorities, acceptance of the coordinating role of the Ministry of Finance (MoF) and at the sector level a coordinating ministry, and discipline and control in both the management of bids and in budget execution.
- 3.14 OECD and some middle-income countries have introduced MTEFs. However, in the 2007 OECD ‘Budget Practices and Procedures Survey’, which covers the 30 OECD members and an additional eight countries, only 19 had multi-year expenditure targets – 13 at an aggregate level, four at ministry or agency level, and two at line item level. Donors have supported the introduction of MTEFs in the context of poverty reduction strategies in several developing countries (ODI 2005). Based on experiences in nine African countries, Le Houerou and Taliercio (2002) found that many MTEFs were not part of the annual budget process, political engagement had been limited, and budget behaviour unchanged. An evaluation by Holmes and Evans (2003) of MTEF implementation in eight African countries and Albania, showed that overall results had been mixed with only South Africa and Uganda (possibly) in the maturing category. They also noted that following the initial study, progress in Albania and Rwanda was actually going backwards. A more recent World Bank (2008: 48) report states “although MTEFs have been challenging for many developed countries, Albania, Burkina Faso, South Africa, Tanzania, and Uganda have adopted well-functioning systems, with Bank support.”
- 3.15 Schiavo-Campo (2008: 7) is less convinced of the success of MTEF implementations, and states that “the lesson from the discouraging MTEF experience so far is certainly not to forget the need for a medium-term perspective for the annual budget, but to re-size, redefine and reformulate the MTEF approach in a manner suitable to the possibilities and constraints of the different countries”. Six years earlier, Le Houerou and Taliercio (2002) came to a similar conclusion. They noted that the introduction of an MTEF is a complex, political and institutional task, not just a technical one. As a ‘bundle of items’, there is no single method of implementation, reforms need to be tailored to the country context, and sequenced as part of the overall PFM reform programme. It would appear that few lessons were learnt from the earlier evaluations.

## ***Performance Budgeting***

- 3.16 A key reform in budgeting is the move from an emphasis on inputs, to a focus on performance, outcomes or results. OECD (2008c) defines performance budgeting as budgeting that links the funds allocated to measurable results. There are three broad types<sup>19</sup>: presentational, performance-informed and direct performance budgeting. The concept of performance budgeting has a long history. During the fifties and sixties, the terms ‘performance budgeting’, ‘programme budgeting’ and ‘planning, programming, and budgeting systems’ were first used, and to a certain degree practiced, in the United States. It is an integral element of NPFM, but there is no single model.
- 3.17 OECD countries have introduced performance budgeting for different reasons, in different ways and at different speeds (Australia – incremental, Korea – radical). According to OECD (2008c), the main objectives of improving the allocation and use of funds, enhancing public sector performance and improving accountability are common across all countries. Based on research and country experience, OECD (2008c) notes that there is a need to customise the approach to the country context, design reforms with the end user in mind, involve key stakeholders in the design process and develop appropriate incentive systems for civil servants and politicians. In implementation, they also note that it is important to: i) select an approach appropriate to the wider governance and institutional structures; ii) gain the support of political and administrative leaders; iii) have information systems that communicate with each other; iv) consider how changes to budget rules influence behaviour, positively or negatively and v) recognise the limitations of performance information.
- 3.18 For reformers in developing countries, it is important to note that “although there are exceptions, most [OECD] governments are finding it difficult to provide decision makers with good quality, credible and relevant information in a timely manner, let alone incentives to use this information in budgetary decision” (OECD 2008c: 7). Diamond (2003b) identifies the following prerequisites before embarking on this road: i) setting of existing programme structure in the wider context of strategic planning and medium-term budget frameworks; ii) redesigning of existing programme structures; iii) improvement of budget-costing systems and associated skills; and iv) introduction of a new system of accountability and budget incentives. After studying seven case studies of poor countries<sup>20</sup>, ODI (2003) concluded that performance orientation could improve both their accountability and overall performance. However, Robinson (2007) is of the opinion that performance budgeting is not relevant for all situations. For real benefits, budget basics need to be in place, and there should be a real political interest in effective expenditure.

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<sup>19</sup> See Annex 1.

<sup>20</sup> In Africa, Latin America and South East Asia.

## **Predictability and Control in Budget Execution**

### *Tax Revenue Administration*

- 3.19 The aim of tax administration reforms is to increase voluntary compliance, as well as increasing revenue and reducing evasion. In developing countries, general tax administration reforms<sup>21</sup> continue to receive significant levels of financial and technical support<sup>22</sup>. Reviews of case studies and project completion reports<sup>23</sup> show that success in general tax administration reform needs: i) high level political and senior management support; ii) to be embedded in broader public sector reforms, so as to avoid unsustainable ‘islands of excellence’; iii) to be supported by broader public sector reforms, including anti-corruption and civil service reforms and iv) appropriate use of change management techniques (Hestad 2005, Robson and Engelschalk 2006). Zuleta *et al* (2007) also attributes the successful introduction of revenue administration reforms in Bolivia and Latvia to political and public support, as well as being part of wider public sector reforms. According to the World Bank (2008: 58) patience is also required, as “most of the Bank’s tax administration investment projects lasted five to seven years, and more than 80 percent had to be extended to achieve the desired results”.
- 3.20 In OECD countries, the tax relationship underpins formal mechanisms of political accountability (IDS 2005). In a study on culture and taxation, Witt (2006) concluded that cultural factors influence tax policy, that the form of government affects the level of voluntary tax compliance, as does the citizen’s perception of government (legitimacy and efficiency). Robson and Engelschalk (2006), note that the affect of performance and behaviour of tax administration on investment, doing business and state building, is not well understood. Clearly, transparency is one important element of building a taxpayer culture. The South African Revenue Service (SARS) uses the media to name and shame tax evaders, while Morocco, Turkey and Peru have all introduced website based information on customs (Hestad 2005).
- 3.21 Another example of a tax initiative gaining significant momentum is the Extractive Industries Transparency Initiative (EITI), launched in 2002. It was designed to improve transparency of both payments made by companies (e.g. oil and mining), and corresponding revenues received by governments. The EITI is described as a ‘world first’ in which governments, civil society, companies and investors are all directly involved in the development and governance of the initiative, with the technical and financial support of IFIs. The Nigerian EITI is considered a particularly good example that goes beyond the global initiative.

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<sup>21</sup> Literature on the introduction of SARAs is discussed in *para. 2.33*. Other general reforms include the introduction of e.g. single tax identification numbers, less discretion in tax assessments, improved taxpayer information and tax appeals mechanisms.

<sup>22</sup> Since 2001, DFID has undertaken 181 tax and tax-related projects/programmes in 44 countries with a financial commitment totalling some £159 million (DFID 2007a).

<sup>23</sup> DFID’s project completion reports in Mozambique, Jamaica, Ethiopia, Zambia and Rwanda.

However, a civil society coalition, ‘Publish What You Pay’, raises serious concerns about the gap between rhetoric (commitments) and reality (action) in many countries (RWI 2006).

### **Cash and Debt Management**

- 3.22 Cash management requires adequate cash flow forecasting, as well as effective and efficient use of cash balances<sup>24</sup>. In the management of cash balances, most authors suggest that the creation of a Treasury Single Account (TSA)<sup>25</sup> is the only solution (Schiavo-Campo and Tomassi 1999, Dorotinsky and Pradhan 2007). Institutional arrangements vary from a TSA in a central bank with direct payments, to use of commercial banks, zero-balance arrangements and nightly sweeping. Many developing countries have implemented some variant of a TSA, but there does not appear to be many evaluations of the overall impact of this reform.
- 3.23 “The main objective of public debt management is to ensure that the government’s financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk” (IMF and World Bank 2003: 5). The World Bank and IMF have provided significant support to middle-income countries in this area. For low-income countries, debt management has had a lower profile, although several donors have provided support to aid coordination offices. These governments and IFIs recognise that work needs to be done in the broader area of debt management, if the gains from the various debt relief initiatives are not to be lost (IMF and World Bank 2007). A new debt management performance assessment (DeMPA) framework<sup>26</sup> has recently been developed to provide the information base for any reform effort.

### **Procurement**

- 3.24 A well-organised, efficient and transparent public procurement system is a vital component of any sound PFM system and transcends the budget process from procurement planning to audit. “Public procurement systems are at the centre of the way public money is spent since budgets get translated into services largely through the government’s purchase of goods, works, and services” (OECD 2005b: 8). It is widely acknowledged that it is also the process most susceptible to bribery and corruption, with TI estimating that annually US\$ 400 billion is lost worldwide (Ware *et al* 2007).
- 3.25 Procurement reform is taking place throughout the world. Industrialised countries are refining and improving their procurement systems to reflect changes in their purchasing profiles (how and what they buy), middle-income

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<sup>24</sup> This paper does not discuss the many financial instruments.

<sup>25</sup> The Treasury Single Account should be referred to, more correctly, as a Treasury Consolidated Fund (a bank account or a series of connected bank accounts through which all government transactions are processed).

<sup>26</sup> See Annex 2 for further details on both the DeMPA and BIS.

countries are modernising their systems in response to growing public demand for greater efficiency and effectiveness, and transition economies, moving from a state driven to a market based economy, are developing competitive public procurement practices (Hunja 2001). In many developing countries, procurement systems were based on pre-independence regulations and are now being modernised to improve their efficiency and reduce the potential for corrupt activities (Hunja 2001).

- 3.26 Key principles of procurement reform include the promotion of: i) rules-based systems; ii) competition; iii) transparency; iv) accountability and v) economy and efficiency. A well functioning procurement system is therefore one that has a strong legal framework<sup>27</sup>, institutional arrangements that ensure consistency in policy formulation and implementation, and a professional cadre of procurement personnel. However, according to Søreide,(2002) and Syquia (2007), the key challenge is to adapt these principles to the overall governance conditions in the specific country.
- 3.27 First generation reforms in developing countries addressed the rules, but paper-based rules are worthless without political commitment (Søreide 2002). Second generation reforms are attempting to improve performance and practice, modernise systems (including e-procurement) and improve professional standards. Until recently, monitoring of progress and evaluation of reforms has been rather subjective. The Round Table on Strengthening Procurement Capacities in Developing Countries, a joint initiative of the World Bank and the OECD DAC, has developed a benchmarking tool - ‘the Methodology for Assessment of National Procurement Systems’. This methodology was officially launched in 2008, to “support the implementation of the Paris Declaration principles by building reliable public procurement systems” (OECD 2008a: 1).
- 3.28 An explanation of the two types of indicators developed by the Round Table is provided in Annex 2. As the methodology has only recently been launched, assessment of the progress of the more recent reforms is still quite subjective. In Central and Eastern Europe, progress is reported to have been mixed; however, a degree of ‘success’ has been achieved in some countries, whereby some element of competitive public procurement has been introduced (Hunja 2001). A comparative lack of success in developing countries is attributed to deeply vested interests, a lack of political will, a paucity of technical knowledge and the complexity of the institutional issues involved (Hunja 2001). The critical need for associated improvements in budget management, personnel management and staff capacity are also stressed (Ware *et al* 2007).
- 3.29 A case study on procurement reform in the Philippines noted, “the reform was enabled and sustained by a broad coalition of support (officials, legislators, external partners, civil society) that was explicitly built and managed by the key drivers of the reform in Government. Without this coalition, the reforms could

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<sup>27</sup> The United Nations Commission on International Trade Law (UNCITRAL) model is used as a guide by many countries.

not have succeeded” (Thornton 2006: 18). Campos and Syquia (2006) referring to the same reform noted that it was better to have strong government ownership of less than perfect reform, than limited or no ownership of state of the art processes.

- 3.30 Despite significant investments in procurement reform in developing countries, Evenett and Hoekman (2005: 14) conclude, “much tends to be claimed for the benefits of procurement reforms. However, there is little analysis whether these benefits were realized after reform initiatives occurred”.

### ***Payroll Management***

- 3.31 Payroll costs often constitute more than 50% of recurrent costs. In the social sectors, the figure is often as high as 90%. Payroll, like procurement, requires careful planning, budgeting, execution and audit and therefore transcends the whole budget process. The importance of sound payroll controls to curb corrupt payments and the existence of ghost workers is cited in a few reports (Dorotinsky and Pradhan 2007). Similarly, the importance of payroll controls to an effective PFM system is recognised in the PEFA indicators. Allen and Tomassi (2001) also discuss alternative payroll scenarios (centralised and decentralised systems). Generally however, the importance of effective payroll controls or sound payroll budgeting appears to have received little attention in the literature.
- 3.32 The failure of civil service reforms in many developing countries is well documented (Polidano 2001). Yet there seems little (or no) research on the progress, impact or sustainability of associated payroll reforms, several of which have included the introduction of automation (and frequently integration) of payroll and personnel systems. Indeed, according to the World Bank (2008), of the 19 case studies of civil service and administrative reform, the most frequently supported initiative by the World Bank was payroll and human resource databases. Only Ghana’s ‘failed’ integrated personnel and payroll database receives any real attention (Sharples 2008). Kizilbash Agha (2007) also argues that this lack of attention to the significance of payroll costs in budget formulation, particularly for social sectors, undermines service delivery.

### ***Internal Controls and Internal Audit***

- 3.33 Effective internal controls are essential for the integrity of the overall PFM system, yet there is surprisingly little discussion on this topic. Technical guidelines on internal controls standards were prepared in 1992 and revised in 2004 (INTOSAI 2004). These guidelines set out a framework for internal controls including the objectives and five main components of internal control, which are the control environment, risk assessment, control activities, information and communication and monitoring. Importantly, the guidelines stress that all personnel in an organisation play an important role in making internal control work.
- 3.34 Reforms in developing countries have tended to concentrate on control activities, particularly the introduction of automated expenditure commitment controls. There appears also to be very limited references to the safeguarding of assets and information, both of which are of particular relevance in conflict or

disaster-prone environments. The overall control environment<sup>28</sup> has also received only limited attention, although recent Ghanaian and UK audit reports have cited improvements in management oversight as a key requirement for reducing fraud and corruption (Dorotinsky and Pradhan 2007). In the 2001 and 2004 HIPC assessments, internal control has shown the least progress. There does not appear to be a lot of research on the reasons for this lack of progress in internal control reforms.

- 3.35 Internal audit (IA) receives significantly more attention, both in the literature and in reform efforts. In the UK and Northern Europe, reforms have mirrored the changes in managerial accountability. Over the last 30 years, IA has been re-organised from a ‘turn and tick’ to a system-based approach, providing management with advice and assurance. This organisational model is not universally applied, and other countries in the OECD (particularly continental Europe) retain third party *ex ante* type functions (Diamond 2002b).
- 3.36 For developing countries, there is considerable debate as to the most appropriate structure and functions; some argue that there is still a need for a centralised function with a continuing role in compliance and regularity (Diamond 2002b, Hepworth 2004). Others, although recognising the time and indeed the change in culture required, still argue that a more independent system-based audit is the way forward (Van Gansberghe 2005, Rameesh 2003). The professional standards<sup>29</sup> for internal auditing, which cover independence, professional proficiency, scope of coverage, performance of audit work and management of audit department, support this view.
- 3.37 Although IA is recognised as an important function in the ‘fight’ against corruption, there appears to be comparatively little written on how effective follow-up of recommendations can be achieved. However, experience in South Africa and Kenya<sup>30</sup> suggests that IA achieves better results when working together with management rather than in a more confrontational or policing role (Van Gansberghe 2005).

## **Accounting and Reporting**

- 3.38 “Consolidated year-end financial statements ... are critical for transparency in the PFM system” (PEFA 2005: 45). Statements need to be understandable and provide information in a consistent manner. In the last twelve years, the Public Sector Committee of the International Federation of Accountants (IFAC) has

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<sup>28</sup> Elements of the control environment include personal and professional integrity, commitment to competence, tone at the top (management style), organisational structure and human resources policies and practices.

<sup>29</sup> Internal auditing standards are issued by a number of bodies; the most recognised are those of the Institute of Internal Auditors (IIA).

<sup>30</sup> The introduction of risk based internal audit in Kenya is documented in the World Bank’s new financial solutions series.



established a set of public sector accounting standards<sup>31</sup> for General Purpose Financial Statements (GPFS), prepared on either a cash or accrual basis. Differences between International Public Sector Accounting Standards (IPSAS) and statistical bases of financial reporting have also been analysed and recommendations for convergence made (IFAC 2005).

- 3.39 The debate on the use of the accrual basis in the public sector has a long history. In the context of NPM reforms, with their emphasis on performance, a need was identified to introduce the accrual basis in order to “encompass accounting and reporting on the allocation and use of total economic resources (both cash and non cash) at the disposal of managers” (OECD 1993: 3). Although, Diamond (2002a) rejects any assumption that performance budgeting requires accrual accounting. OECD (2002a) argues that accrual accounting cannot be introduced successfully without accrual budgeting. “More recently, led primarily by the international agencies, such as the OECD, the IMF, and the World Bank, and by some international accounting bodies, such as IFAC, countries have been strongly encouraged to adopt the accounting system generally used by the private sector: accrual accounting” (Boothe 2007: 181). However, even after almost two decades, questions remain; whether the accounting needs of the public sector, which revolve around democratic accountability, are well served by private sector-based accounting that revolve around financial performance and profitability (Boothe 2007).
- 3.40 What appears to be lost in some of these arguments is that cash and accrual accounting are not mutually exclusive concepts, but rather opposite ends of a spectrum. Accrual accounting is a means not an end in itself. Moving along the spectrum can be done gradually (Allen and Tomassi 2001, Athukorala and Reid 2003). Currently only one third of OECD countries have adopted full accrual accounting, either for the whole of government accounts or at ministry or agency level. Important lessons from the introduction of accrual accounting in OECD countries are that: i) the transition is not just a technical exercise, it requires a culture change and needs to link with wider public sector management reforms; ii) the phasing of implementation needs to be carefully planned; iii) there is a need for greater accountancy skills and appropriate IT systems; and iv) the importance of communication, particularly with users such as parliamentarians, media and the public should not be overlooked (OECD 2002a, Diamond 2002a, Athukorala and Reid 2003).
- 3.41 Many developing countries are considering, or are in the process of moving to, accrual accounting e.g. The Philippines (JBIC 2001). Many authors view its introduction in developing countries as inappropriate, because of the lack of technical capacity, the need for sophisticated judgements, vested interests and greater potential for creative accounting<sup>32</sup> (Diamond 2002a, Athukorala and Reid 2003).

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<sup>31</sup> A list of countries adopting IPSAS either on cash or accrual basis can be found at [http://web.ifac.org/download/IPSASB\\_Adoption\\_Governments.pdf](http://web.ifac.org/download/IPSASB_Adoption_Governments.pdf).

<sup>32</sup> This does not mean that creative accounting cannot take place under a cash basis.

3.42 Allen and Tommasi (2001) list the principles of good reporting as completeness, legitimacy, user-friendliness, reliability, relevance, consistency, timeliness, comparability and usefulness. The need for timely, accurate and complete reporting is the basis for two performance indicators in the PEFA framework (PEFA 2005). The implicit assumption for non-production of timely reports is lack of capacity, but no research could be found to verify this assumption.

## **External Audit and Legislative Scrutiny**

### *External Audit*

3.43 Supreme Audit Institutions (SAI) have a vital role in holding government to account and ensuring transparency in government operations. Although, there are differing models for external audit<sup>33</sup>, all models are guided by the fundamental objectives set out in the Lima declaration, and the international standards of auditing developed by the International Organisation of Supreme Audit Institutions (INTOSAI)<sup>34</sup>. In response to the growing performance-orientation of the public sector, performance (or value for money) auditing is widespread in Europe, Australia, New Zealand and North America and developing elsewhere. There is also a growing emphasis on the central position of SAIs in their country’s national integrity system and their role in detecting and reporting on corruption and fraudulent practices. In the nineties, several developing countries were already ahead of their industrialised partners in this respect (Dye and Stapenhurst 1998).

3.44 In developing countries, donors frequently support SAIs either directly or indirectly e.g. through a particular project or sector programme. The HIPC update surveys showed positive progress for external audit reform. Guidance on SAI reform emphasises the long term<sup>35</sup> (ten years plus) and country specific nature of reforms (DFID 2005c, INTOSAI 2007). The need to prioritise the development needs of an SAI’s senior management is also stressed. At the same time, based on experience in Eastern Europe, Brazil and several other countries, a number of potential quick wins are identified including: i) reprioritising resources; ii) improving publicity; iii) writing better recommendations; iv) making reports more user-friendly; v) enhancing audit documentation; vi) developing a SAI ‘vision’; vii) improving communications with audited bodies and viii) using pilot audits as learning experiences (DFID 2005a).

3.45 According to DFID (2005c), recent research shows that reform techniques including peer reviews, twinning arrangements, development of technical training capacity and contact committees appear to be succeeding in both accession and developing countries. EU accession countries frequently request

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<sup>33</sup> Westminster model – UK and most commonwealth countries; Judicial model – Latin countries in Europe and francophone countries; Board or Collegiate model – Germany, the Netherlands, Indonesia, Japan and Korea.

<sup>34</sup> INTOSAI is divided into several regional bodies to provide additional support and guidance.

<sup>35</sup> Sweden’s Auditor General only obtained full independence in 2003.

peer reviews. Twinning arrangements are also proving to be effective. The Swedish Audit Office has been providing support to the audit offices in Namibia and Mozambique for some time. The UK’s National Audit Office (NAO) is providing support to several audit offices including Ghana,<sup>36</sup> where a number of improvements have been made. In Latvia, the creation of a technical development-training unit has helped to improve the capacity of auditors. English speaking countries in Africa and EU candidate countries have created ‘contact’ committees (a regional forum of audit offices) to help resolve common problems and issues (DFID 2005c). The problem of effective follow-up is one that is shared by many audit offices, and an area where civil society is also making important contributions (*para. 4.37*).

### ***Legislative Scrutiny***

- 3.46 Even as far back as the 14th century the English Parliament had some power over the purse, when it was ruled that no taxes could be raised from citizens without parliamentary consent, and commissioners were appointed to audit tax collectors (Stapenhurst 2004). In most countries the budgetary role of the legislature is both *ex ante* (approval of the budget and/or change) and *ex post* (oversight) (Wehner 2004, Stapenhurst 2004, Lienert 2005). The particular emphasis varies. Some research suggests that parliaments in a Westminster-type system focus on a strong *ex post* review, primarily done through the Public Accounts Committee (PAC). On the other hand, legislatures in presidential systems, such as the USA and France, focus mainly on strong *ex ante* review of budgetary control and resource allocation (Stapenhurst undated). The role of legislatures in semi-presidential systems varies within this spectrum.
- 3.47 From a development perspective, the importance of the legislature in overseeing government activities has only recently come to the fore. As Santiso (2004) points out, donor support to PFM reforms in the nineties, focussed on the executive and on improving technical systems: only with ‘second generation’ reforms is the role of the legislature being fully recognised. This ‘new’ emphasis has led to an increase in research on the role of the legislature, particularly its ability to engage in the budget process. A number of factors influence legislative participation. These include: i) the political system; ii) the constitutional power to amend the budget); iii) the party political dynamics; iv) the legislative budget research capacity; and v) access to relevant information. Other factors mentioned are enough time for scrutiny, donor interests and aid conditionalities (Wehner 2004).
- 3.48 Although some research has been done on the relationship between the legislature and the executive (Wehner 2004, Lienert 2005), it seems that the current research emphasis is more on legislative oversight and specifically the role of the PAC in Westminster systems (McGee 2002, Stapenhurst *et al* 2004, Pelizzo and Stapenhurst 2004a). *Figure 7* shows a model of an ‘ideal PAC’<sup>37</sup>.

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<sup>36</sup> The progress of Ghana’s audit reform is documented in the WB’s FM solution series.

<sup>37</sup> Many non-commonwealth countries e.g. Germany, France, East European, Francophone African and Latin American countries have established committees similar to the PAC (Stapenhurst 2004).

According to McGee (2002), the development of a PAC should focus on capacity-building, ensuring independence and information exchange. Hudson and Wren (2007) argue that failure of legislative strengthening exercises are frequently the result of a lack of proper attention to political, cultural and social realities, at both design and implementation stage.

3.49 An increasing number of players, multi-lateral and bi-lateral agencies, research institutions and parliamentary networks are now involved in providing support for parliamentary strengthening. Hudson and Wren (2007) argue that there is very limited independent, systematic and comprehensive evaluation of results. Stapenhurst *et al* (2008) provide some examples of recent reforms e.g. the budget committee and technical support unit in Uganda. There may also be scope for more research, for example on variants from the ‘ideal’ PAC, particularly in the Caribbean and in Small Island Developing States (SIDS) generally.

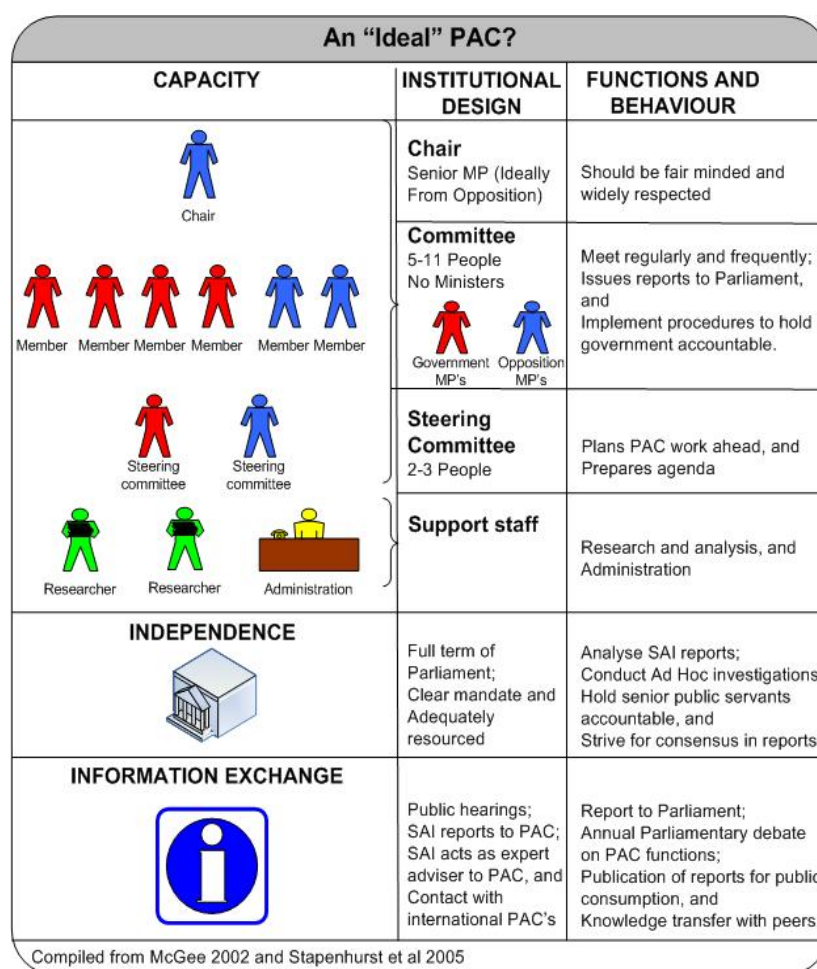


Figure 7 An ‘ideal’ PAC

## Crosscutting Issues

- 3.50 Legislation, automated systems, gender issues, training and change management<sup>38</sup> cut across all the PFM components discussed above.
- 3.51 *Legislature:* The legal basis for national budget systems varies considerably amongst OECD countries: Norway and Denmark have no formal statutes to guide the budget process; the US has several budget-related laws (Lienert and Moo-Kyung 2004). In developing countries, many donors have been promoting changes in legislation, and in some countries e.g. Rwanda, new organic budget laws have been implemented. However, other observers note that the regulatory framework itself is not always the problem, but rather compliance with it (Lienert 2003), and that limited capacity does not mean dysfunctional financial procedures (Peterson 2006). Introduction of new legislation alone is therefore unlikely to achieve desired changes.
- 3.52 *Automated systems:* In developing countries, automated systems, particularly IFMIS have become synonymous with PFM reform, seen by some as even drivers of reform. They are often considered as the answer to the problems of lack of reliable and timely data and poor financial controls. Yet as Peterson (2006) observes, unlike other multi-million dollar investment projects, in many cases, cost-benefit analyses have not been undertaken.
- 3.53 Diamond and Khemani (2005) promote the use of a modular approach to IFMIS implementation, with the initial introduction of just the core functions of budget execution, accounting, payment processing, commitment control and financial reporting. Based on experience in Ethiopia, Peterson (2006) argues that process change not process (innovation) re-engineering is the best method.
- 3.54 In Eastern Europe, comparative success in IFMIS implementation is attributed to the fact that the whole regulatory and institutional framework of public finance was new. Traditionally, in many Latin American countries, budgetary and expenditure management was fragmented and therefore simple integration achieved through automation was viewed as beneficial (Heidenhof *et al* 2002). Success in Guatemala is attributed to the initial emphasis on basics (Wescott 2008). Conversely, in Africa, the PFM ‘problem’ was perceived to be pervasive informal behaviour and failure to follow the rules. The focus for the introduction of an IFMIS was therefore not on integration, but rather on how to ensure compliance with rules (Heidenhof *et al* 2002). Other reasons cited for the failure of IFMIS’ implementations include: i) lack of clarity in ownership; ii) failure to clearly specify basic functionality; iii) insufficient design phase; iv) failure to re-engineer procedures; v) failure to undertake parallel reforms; vi) unrealistic time-scales; vii) lack of incentives for reform; and viii) neglecting to ‘sell’ the system (Diamond and Khemani 2005). Whether these lessons have been heeded in recent implementations, or in the roll out of existing applications does not appear to have been evaluated.

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<sup>38</sup> Training and change management issues are discussed in the next chapter.

- 3.55 *Gender responsive budget analysis (GRB)*: GRB involves analysing and reordering budgetary priorities from a gender perspective. GRB is not about having separate budgets for women or men (Leadbetter undated); or about budgets being divided equally. It is about evaluating the impact of revenue raising and expenditure allocation, determining the different needs of men and women, and allocating resources accordingly. Analysis may be carried out at national, provincial and municipal levels.
- 3.56 Australia was the first country to implement gender-sensitive budgets in 1984. Parliamentarians and civil society in South Africa introduced gender-sensitive budget analysis in 1995. Now, some form of gender budgeting has been introduced in more than 40 countries, many promoted by donors; although, no uniform methodology has been used.
- 3.57 GRB initiatives can be measured in terms of changes in budget priorities, and the extent to which women begin to participate in budgetary debates and decision-making. The evidence of positive results is mixed. UNIFEM (2005) and Sharp (2007) claim that GRB can be a positive force in promoting a more equitable distribution of public resources and benefits of development for women and improving overall budgetary processes and outcomes. UNIFEM (2008) also claims that GRB initiatives have contributed to structural changes where finance ministries are instituting policies that ensure budgeting from a gender perspective, as is seen at the national level in Morocco, Egypt, India and Venezuela, and at the local level in India, Nepal, Ecuador and Bolivia.
- 3.58 However, various literature suggests that issues of sustainability, ownership and capacity present significant challenges. To be fully effective, obstacles such as gender biased culture, lack of appropriate budget classifications, lack of gender analysis expertise, and gender disaggregated data needs to be overcome (Sarraf 2003; Commonwealth Secretariat 2002). Stotsky (2006) identifies a number of important lessons including the need to: i) include civil society for support and assistance; ii) adapt programming to address specific and identifiable concerns and iii) not set (as a rule) specific spending goals for women-related objectives

## **Summary**

- 3.59 *Monitoring and Evaluation*: In the past, most diagnostic reviews of PFM systems were not designed to monitor the progress of reforms. The PEFA framework introduced in June 2005 now enables assessment of reform progress. Evaluations have not always used the OECD evaluation criteria; consequently, many findings and conclusions are based on observations and experience rather than objective data. This does not imply that positive outcomes have not been achieved, but rather that subsequent independent verification is difficult. Many donor-funded evaluations of PFM reforms have focussed on their technical assistance, rather than the relevance, impact or sustainability of the ‘technical’ reform itself.
- 3.60 *Comprehensiveness and Transparency*: In heavily indebted countries, reform of budget classification is reported to have shown major improvement. A more practical issue is whether any of these reforms have resulted in greater transparency and/or more user-friendly information for legislative, management or public use.

- 3.61 *Policy-based budgeting*: The introduction of MTEFs has been widespread and often linked to the development of a poverty-reduction strategy (PRS). In 2002, initial evaluations showed limited success, because of the highly complex, political and institutional nature of the task. Current literature is divided on the level of success, some repeating the concerns of earlier evaluations. The move to performance-based budgeting is taking place worldwide. Evaluations of OECD experience suggest that there is a need to customise the approach to the country context, and develop appropriate incentive systems for civil servants and politicians.
- 3.62 *Predictability and control in budget execution*: The aim of *tax administration* reforms is to increase voluntary compliance, as well as increasing revenue and reducing evasion. Country experience suggests that success requires time, high-level political commitment and public support, and to be embedded in and part of wider public sector reforms.
- 3.63 *Procurement reforms* are taking place worldwide, as a well-organised, efficient and transparent public procurement system is a vital component of any sound PFM system. Recently, modernisation of procurement systems in developing countries has received increased attention. The literature highlights the lack of objective evaluations of current reforms and the fact that objective indicator-based assessments have only recently been launched. Experience in the Philippines does show that success has been achieved through widespread support and strong ownership of less than perfect reform, rather than no ownership of state of the art practices.
- 3.64 *Payroll* costs constitute a significant percentage of recurrent costs. Support to payroll reforms has concentrated on the introduction of automated systems; however, there appears to have been no evaluation of their effectiveness, either in terms of improving controls or in improving medium-term planning processes.
- 3.65 *Internal controls* in heavily indebted countries have not improved significantly, although no clear explanation is provided, as to why progress has been so limited. Debate continues on the best role for internal audit in the public sector. Experience in Kenya and South Africa suggests that the traditional ‘policing’ role is not effective.
- 3.66 *Accounting and reporting*: The importance of timely, consistent and comprehensive reports is emphasised in PFM reform literature, and efforts to improve consistency and comparability have been made through the introduction of IPSAS. The academic debate on the advantages and disadvantages of accrual accounting (and budgeting) continues. OECD experience shows that the move from cash to accrual accounting needs careful planning, and to be part of wider public sector reforms.
- 3.67 *External scrutiny and audit*: SAIs have a vital role in holding government to account and ensuring transparency in government operations. Generally, audit reforms take a long time, although a number of quick wins have been identified. Reviews suggest that audit reforms have benefited from peer-learning practices including twinning arrangements, contact committees and other regional affiliations. ‘First-generation’ PFM reforms in developing countries concentrated

on technical issues, ‘second-generation’ reforms have recognised the need to enhance the role of the legislature and thus improve domestic accountability. The lack of evaluations on the effectiveness of support provided to legislatures is identified in the literature.

- 3.68 *Cross cutting issues:* In developing countries, many donors have been promoting changes in legislation, but the literature notes that lack of compliance is often the major issue, and new legislation alone is unlikely to achieve desired results. Automated systems, particularly IFMIS have become synonymous with PFM reform, seen by some as even drivers of reform. Failure rates were reportedly high, because of unrealistic timescales, lack of ownership, insufficient consultation and inadequate specifications. Evidence of improved success rates was not found. Gender responsive budget analysis, now introduced in more than 40 countries, is producing mixed results in moving towards more equitable distribution of public resources.



## 4. PFM Reform – Putting the Theory into Practice

### Introduction

4.1 Polidano (2001) argues that most reforms fail not because of the contents or technical aspects of the reform programmes, but because of the way they were implemented. This chapter reviews available literature on some of the other factors influencing PFM reform. In particular, it covers the importance of country context; whether the country has the capacity to implement the reforms; PFM reform and improved service delivery; and the role of external stakeholders.

### Country Context

4.2 Most observers now agree that policies and procedures cannot be transferred, without taking into account individual country circumstances (Schick 1998b). Indeed Schiavo-Campo and Tommasi (1999) consider the importation of ‘best practices’ a dangerous term without hardnosed consideration of local realities. All reforms take place within a specific historical, political, cultural and social environment. Colonial history has often established the foundations of the PFM system. According to Bouley *et al* (2002), the treasury systems of sub-Saharan francophone African countries are still based on the French treasury system of the sixties, and characterised by the unique structure of their expenditure process and the centralisation of public funds. OECD (2006) also stresses that programme design and sequencing should be country specific, e.g. the urgency of payroll reform in post-conflict Sierra Leone, where non-execution represented a significant security risk. In Bangladesh, the decision was made to “start off with the more technical types of issues ...before endeavouring to change areas that would create strong bureaucratic resistance” (OECD 2006: 65).

### Post-Conflict

- 4.3 PFM reform in a post-conflict environment poses a different and complex set of challenges (but also opportunities), particularly as many of these countries are resource rich. There is general agreement that setting up the financial management institutions of governance, alongside addressing the basic causes of the conflict, are important first steps, to both sustainable peace and economic growth (Gallagher 2007, Gupta *et al* 2004, Dwan and Bailey 2006).
- 4.4 The IMF has advocated an alternative approach to PFM reform in post-conflict countries. According to Gupta *et al* (2004), this approach is based on a three-step process of: i) creating a proper legal framework for fiscal management; ii) establishing a central fiscal authority and a mechanism for coordinating foreign assistance and iii) designing appropriate tax policies, while simultaneously creating simple tax administration and expenditure management arrangements. In the midst of chaos, the introduction of new legislation may not seem the most pressing concern, but the IMF (2004b) argues that simple and clear rules can facilitate the whole reconstruction process. Without resources, a government cannot function; without a capable MoF, there are no resources. According to Schiavo-Campo (2007), a credible and realistic medium-term perspective (not a

complex and detailed one), also helps in the generation and disbursement of donor funds. Furthermore, he also stresses that, given the significant volume of pledges in the immediate post-conflict period, the need for a mechanism to coordinate foreign assistance is critical.

- 4.5 The three-step approach was used in 17 post-conflict countries, although with some variations, depending upon country circumstances. According to Gupta *et al* (2004), lessons from the ‘field’ include the need for political support, donor coordination, a flexible approach and longer time horizons for capacity building. This approach has relied heavily on long-term advisers, and according to the IMF (2004b), there is no alternative solution, at least in the early post-conflict phase. The World Bank (2005c) acknowledges that since 2001, PFM in Afghanistan has improved significantly. However, they note that the continuing reliance on external technical assistance is not sustainable “and there are serious risks that slower but more sustainable national capacity development will be undermined, making Afghanistan highly vulnerable to a reduction in aid flows” (World Bank 2005c: x).
- 4.6 An example of a more radical and controversial approach to PFM reform in post-conflict environments was adopted in Liberia. The Governance and Economic Management Assistance Programme (GEMAP) was signed between the transitional government and international partners<sup>39</sup>. This wide-ranging programme targets revenue collection, expenditure controls and procurement. International experts have co-signature authority and management contracts in selected ministries and state-owned enterprises; and there are authoritative oversight mechanisms and linkages to the peace implementation process and to UN Security Council sanctions.
- 4.7 As a potential model for use in other post-conflict situations, a review by Dwan and Bailey (2006) of the initial negotiation and elaboration process highlights some useful lessons, in particular the importance of effective communication strategies and the need for IFI representatives to be more politically astute. A recent UN ‘traffic light’ review<sup>40</sup> of actual reform implementation in Liberia shows positive progress, particularly in revenue administration and expenditure management, although procurement remains problematic. However, strong presidential support for Liberia’s overall reform agenda is seen as a major contributory factor, and one that may not be replicated in other countries.

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<sup>39</sup> In September 2005, the National Transitional Government of Liberia and Liberia’s international partners – the United Nations, World Bank, European Commission/European Union, International Monetary Fund, Ghana, Nigeria, United States, Economic Community of West African States and the African Union, signed a Governance and Economic Management Assistance Programme for Liberia. The Security Council welcomed GEMAP in resolution 1626 of 19 September 2005.

<sup>40</sup> See [www.gemapliberia.org](http://www.gemapliberia.org).

## Capacity Development

4.8 The United Nations Development Programme (UNDP) defines capacity as “the ability of people, institutions and societies to perform functions, solve problems, and set and achieve objectives” (UNDP 2002: 2). The Strengthened Approach to PFM reform emphasises the importance of moving from diagnosis to implementation and in particular building country PFM capacity, although OECD (2006) stresses that country governments, not donors are ultimately responsible for capacity development. There is general agreement that capacity development should take place on an individual, organisational and institutional level. Olander (2007) describes four inter-related elements that need to be considered when assessing and developing PFM capacity ( Figure 8). The first, **resources**, includes the quantity and quality of staff, adequate and timely financial resources, equipment and facilities. The second aspect looks at **management**, which comprises leadership and political will, operational management and change management of the PFM reform programme. The third element, **institutional framework**, takes account of legislation, procedures and organisational culture. The final element relates to **support structures** including the role of tertiary education institutions and professional bodies, the upgrading of skills through training and the role of consultants.

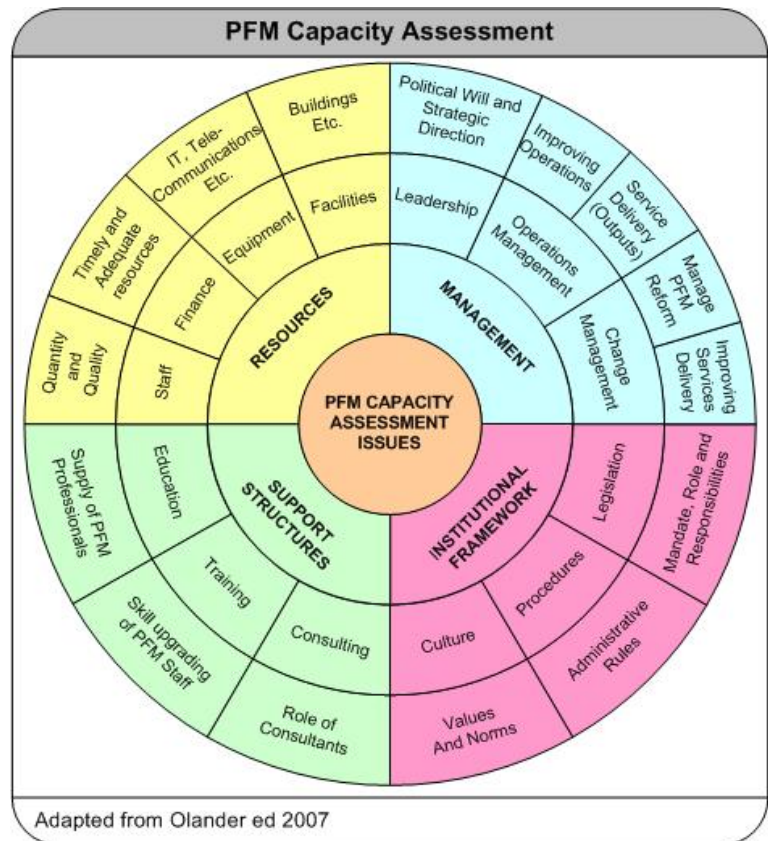


Figure 8 PFM capacity assessment

4.9 The following paragraphs provide a brief summary of the evaluation literature and guidelines. However, the most important trend encompassing all four elements is the guidance to build on existing capacity, not to impose external solutions (OECD 2006).

### Resources

4.10 The key constraint in this area is the quantity and quality of the staff (IMF 2006, AusAID 2004). Many assessments identify the lack of economic and accountancy skills within most institutions, as a major problem in PFM reforms. Clearly, the personnel issue of recruitment and retention of staff highlights the link between financial management and personnel management (civil service) reforms. In external audit reforms, the need for operational independence, in both financial and personnel management, is also frequently raised.

4.11 Although the literature refers occasionally to limitations in resources for the funding of reforms, sustainability of the reforms is the more critical issue. As Diamond and Khemani (2005: 24) note, “it should be recognized that there are recurrent costs associated with the maintenance and operation of major financial management information systems that must be covered in budgets and that often are not considered”. Other authors cite technological constraints e.g. reliability of internet provision, as constraints on the adoption of some types of reforms such as e- procurement (Søreide 2002). Regardless of the level of funding, commitment or technical expertise of the donor agency, investments in capacity development have rarely proved significant or sustainable without national champions for reform (OECD 2006). Hunja (2008) also notes that money alone does not buy real reform.

### **Management**

4.12 In terms of leadership and management, AusAID (2004) stresses the importance of clear partner leadership in the successful implementation of the treasury-strengthening project in Samoa. In its evaluation of several PFM programmes in the South Pacific, it also notes the link in Vanuatu and Samoa between the programmes’ success, and the existence of a clear organisational vision, tied to an overall national reform plan. As noted in *para.* 4.10, some evaluations identify a lack of technical capacity, as a constraint on PFM reform, but the influence of general management capacity on PFM reform does not appear to have been studied. Similarly, little evidence was found of governments or donors using explicit managerial coaching<sup>41</sup> strategies in implementing PFM reform.

4.13 PFM reform literature refers to the need for effective change management (Diamond 2003b, OECD 2006) and provides some examples of successes. In Guatemala and Bangladesh, involving operational staff in the reform process was essential to prevent derailment and ensure sustainability. According to the OECD (2006), the creation of ‘bottom-up’ interest in reform, as well as understanding the organisational culture, were key factors in the programmes’ success.

4.14 In implementing PFM reforms, the OECD (2006, 2008b) also highlights the importance of understanding the broader cultural context. An appreciation of cultural values is aimed at increasing reform sustainability and does not compromise ‘international standards’; however, there appear to be few examples of how those involved in PFM reform incorporate this issue into their change management strategies. There are exceptions. An AusAID (2004: 13) evaluation in the Pacific showed how they introduced cross-cultural change management. “Adviser/counterpart workshops were sponsored by AusAID to support the

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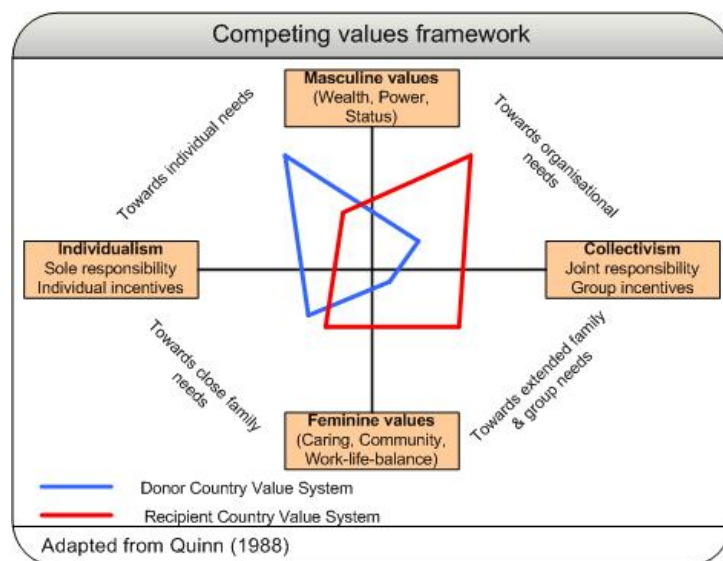
<sup>41</sup> According to Skiffington and Zeus (2003), coaching involves a structured mentor-based process, which includes examining values and motivation, setting measurable goals, defining action plans and using behavioural change management tools and techniques to assist the development of individual or group competencies.

development of the relationship between the two. The workshops explored cultural differences and assisted advisers to develop an understanding of the Samoan context for skills transfer. They helped counterparts understand the imperatives and culture of advisers. The workshops enhanced the working relationship between advisers and counterparts”.

### ***Institutional Framework***

4.15 The previous chapter discussed the procedural and legislative changes associated with PFM reform. The World Bank (2005a) and Olander (2007) refer to the impact of an organisation’s culture, the degree of competition, cooperation and information sharing on PFM reform and the need to improve ethical norms at the institutional and organisational level. Lack of compliance with the ‘formal rules of the game’ is sometimes attributed to vested interests and informal practices that undermine the system (*para.* 2.27); however, Haller and Shore (2005) point out that people may not always attach the same meaning to a particular concept e.g. gift giving in Kazakhstan. Similarly, in an accountability study in Tanzania, Lawson and Rakner (2005: 28) found that “MPs are largely judged by voters according to their ability to ‘bring the goods home.’ As a result, MPs see themselves as ‘accountable’ for providing tangible benefits to their constituencies”.

4.16 The importance of understanding different cultural perspectives in implementing reforms, and how cultural values help shape people’s behaviour, is well documented in general management literature (Hofstede 2001, Trompenaars and Hampden-Turner 1997). *Figure 9* explains how competing value systems could undermine a reform process e.g. individual performance incentives may be inappropriate in a collectivist society. In PFM reform literature, Andersson and Isaksen (2003) ask whether culture is ignored in practice, because it is not regarded as important or whether it is too difficult, sensitive or threatening to study.



**Figure 9 Competing Values Framework**

### ***Support Structures***

4.17 Support for PFM reform in developing countries is provided at a number of levels. Support for national, regional and sub-regional organisations e.g. Eastern and Southern African Association of Accountant Generals (ESAAAG) has proved effective in improving capacity and sharing knowledge (Andersson and Isaksen 2003). In South Africa, the Institute of Public Finance and Auditing (IPFA) has established professional training schemes for public sector accountants. OECD (2008b: 22) notes, “South-South knowledge sharing is increasingly proving useful in addressing the similar problems faced by countries at similar stages of

development”. Communities of practice such as the public expenditure management peer assisted learning (PEMPAL) group in Eastern Europe and the Collaborative Africa Budget Reform Initiative (CABRI) have been established to share experience on reform programmes.

- 4.18 The comparative effectiveness of various forms of training (e.g. workshop, on-the-job training, mentoring) on the success of PFM reforms does not appear to have been studied. Although it is worth noting that, as part of their evaluation of their assistance in the South Pacific, the AusAID (2004) evaluation did find that on-the-job training was the most effective in all three countries visited, and well regarded by senior managers and project teams for the results achieved. More generally, a lack of proper training strategies within the civil service is cited as a constraint on PFM reforms (World Bank 2005b).
- 4.19 In terms of international consultancy support, the quality of technical knowledge is generally acknowledged; however, in some instances, own interests, lack of cross-cultural management skills, poor interpersonal skills and lack of understanding of inter-institutional dependencies is reported as reducing its effectiveness (AusAID 2004, ADB 2000, IMF 2006).

## **Service Delivery and PFM Reform**

- 4.20 Recent literature has highlighted the link between effective PFM systems and poverty reduction. Weaknesses in PFM affect efficient service delivery, as illustrated in several Poverty Expenditure Tracking Surveys (PETS), and many sector Public Expenditure Reviews (PER) show that funds do not always flow as intended. The following two sub-sections look at PFM reform to date from the sector and the sub-national perspective, while the third sub-section reviews the research carried out on the inter-relationship between PFM reform processes and other reforms e.g. civil service reform.

### ***Sector Perspective***

- 4.21 A sound public financial management system is crucial for the sustainable and successful implementation of a PRS, and indeed the general provision of public services. In developing countries, changes in sector policies and management, especially in the social sectors (health, education) and infrastructure, are regarded as core contributions to poverty reduction and reaching the Millennium Development Goals (MDG). However, the perspective and focus on PFM of the central ministries, particularly the ministries of finance and planning, is different from that of the line ministries. In PFM reform programmes, led by the MoF, the needs of the line ministries to achieve quality and efficiency in spending within and across programmes and to combine financial and non-financial information, seem to receive less attention than the need to control overall government spending and to improve allocative efficiency (Olander 2007, Witt and Müller 2006).
- 4.22 From an overall ‘sector’ perspective, the situation is complicated by the actual provision of services at various levels of government, central (line ministries, autonomous agencies) and sub-national bodies (regional and local). Sector-wide approaches (SWAs) are becoming commonplace in many developing countries,

particularly those that are heavily aid dependent. From an allocative efficiency perspective the development of sector expenditure frameworks (SEF) and sector working groups (SWG) are seen as important components of MTEF implementation (Holmes and Evans 2003). Yet, there appears to be little evaluation of whether sector (e.g. education reform programmes) and PFM reform programmes are mutually re-enforcing or the reverse. In designing an IFMIS, for example, “it is important that it cater to management needs—not just those of the central agencies, but also line agencies...[and] also to support those needs that are likely to arise as parallel budget reforms are implemented” (Diamond and Khemani 2005: 4). The fact that PETS are required because of limited information on resources received at service delivery level, might suggest that this is not always the case. Similarly, the inclusion of NAO in sector groups could be contrary to their legal independence from the national budgeting system.

4.23 At the sector level, the introduction of NPM led to the creation of numerous public agencies, or in the UK, non-departmental public bodies (NDPB). Their creation was accompanied by the development of a comprehensive framework for their governance and financial management. This included financial rules and regulations from the Treasury, audit by the NAO and a set of governance standards and codes of conduct for board members and officers. Support for improvement in governance and management (SIGMA) advocates the adoption of a similar comprehensive framework for Central and Eastern European countries (OECD 2001). In developing countries, despite the proliferation of autonomous or semi-autonomous agencies, comparatively little appears to have been written about their financial management and accountability.

4.24 From a sector perspective, it is also argued that progress as assessed in the HIPC and PEFA assessments may not reflect the situation at line ministries, for example the standard of reporting or the quality and relevance of strategic plans (Andrews 2007). The status of PFM systems is analysed as part of annual PER and PRS reviews and PETS, but no specific evaluation of how overall PFM reforms have affected the ‘sector’ or service delivery level could be found.

**Fiscal Decentralisation (the Sub-National Perspective)**

4.25 Fiscal **decentralisation** (Figure 10) relates to the assignment of expenditures, the transfer of funds, and/or tax-raising and/or borrowing

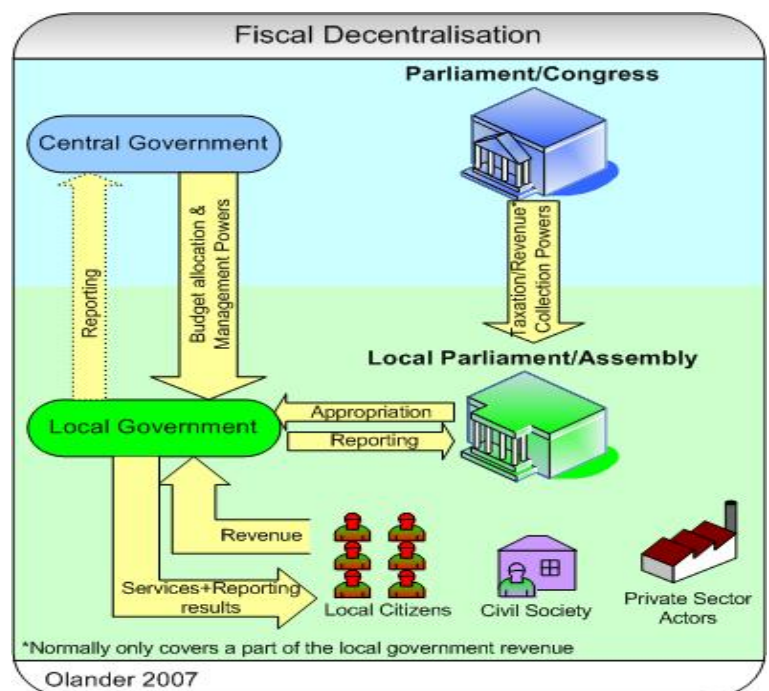


Figure 10 Fiscal Decentralisation

powers from higher levels to lower levels in political systems<sup>42</sup>. From a sub-national (SN) perspective, therefore, there are two levels of PFM reform: its own reform and that of the central government. Due to the vast array of SN arrangements, this paper does not review the literature on SN governments' own PFM reform, its progress or its impact *per se*. Instead, it looks at the literature available on the effect of central PFM reforms on regional or local government.

- 4.26 Tax raising, borrowing powers and the overall level of grants are policy issues. From a PFM reform perspective, allocative transparency requires clear criteria e.g. equitable and clear formulas for the distribution of grants. From a SN perspective, central PFM reforms should also facilitate clear and reliable indications of annual allocations from central government (PEFA 2005, PEFA 2008).
- 4.27 Smoke (2001) recognises that there are many problems in designing appropriate inter-governmental transfer programmes. Given the political nature of transfers, he considers it unrealistic to assume complete objectivity, but notes that the use of more objective and transparent formulas can help move the system in the right direction. UNDP (2005) notes that in Uganda, PETS highlighted problems that led to improved use of grants, and fiscal incidence studies in Tanzania helped with the introduction of formula-based grants.
- 4.28 Assessing the state of inter-governmental fiscal transfers is part of the PEFA framework, but there are few second-generation reports available. Assuming the link (although still being debated) between decentralisation and poverty reduction, there do not appear to be any comprehensive evaluations of whether national PFM reforms have led to improved inter-governmental transfers and thus contributed to poverty reduction. The suitability of national systems (budget classification, automated systems, reporting) for SN levels also seems to be assumed, rather than proven in the literature.

### *PFM and Other Reforms*

- 4.29 In OECD countries, financial management reforms have taken place alongside broader public service reforms. OECD (2008b) concludes that PFM reforms can be better sustained, if they are introduced in conjunction with broader public sector reforms. In a recent evaluation of DFID's technical assistance, one of the key findings was that a "lack of progress in civil service reform emerges as the most significant factor in explaining the limited capacity development ...and this issue (and the constraints it imposes) does not seem to be sufficiently addressed in the various recommendations on capacity development that emerge from the recent evaluation and policy" (OPM 2006: xix).

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<sup>42</sup> On the other hand, fiscal **deconcentration** means a transfer of responsibilities, powers and resources from the central government (ministries and agencies) to field offices at the local and regional level, thereby becoming closer to the citizens, while remaining a part of the central government system (PEFA 2008).



4.30 Many other evaluations of capacity building assistance stress the importance of wider public sector reforms to the sustainability and impact of specific PFM capacity development initiatives (AusAID 2004, OECD 2006, IMF 2006). In contrast, findings from a recent World Bank (2008: xvii) report suggest that there is no evidence that “public sector issues are so interlinked that only comprehensive solutions will work”. The report also ascribes the better reform outcomes for tax administration and financial management to the fact that they are less politically and culturally sensitive than public employment and corruption<sup>43</sup>. However, the report does not discuss the question of the sustainability of PFM reforms, without associated civil service or judiciary reforms.

## **External Stakeholders**

4.31 A number of external stakeholders play an important role in PFM reform: the media in terms of improving public access to financial information, academic institutions and professional bodies acting in both an advisory and training capacity, and contractors and suppliers providing both goods and services. PEFA (2005) acknowledges the role of the private sector in procurement reform. Bouchet and Kariithi (2003) discuss the importance of the media in building an informed society. As noted in *para.3.22*, the media and private sector also play an important role in the EITI. However, there does not appear to have been significant research on the roles of the media or private sector in PFM reform. Consequently, the following sub-sections briefly review some of the more recent PFM reform literature relating to two of the other key players, donors and civil society.

### **Donors**

4.32 “The two most important rules to follow when dealing with developing countries or countries in transition are: (a) do no harm and (b) know your country” (World Bank 1998: 95). In addition, the Paris Declaration requires greater donor harmonisation and alignment to country procedures. OECD (2008b) identifies three risks in providing aid. ***Fiduciary risk***, the risk that funds are not used for their intended purposes, ***development risk***, the risk that the ultimate objectives of the intervention are not achieved and ***reputational risk***, the risk of scandals having a negative affect on a donor’s ability to provide future support. Bilateral agencies, particularly, need to report to their home constituencies, as media reports of waste and abuse of taxpayers’ money could seriously damage their development efforts.

4.33 As indicated throughout this report, greater donor coordination produces better results and reduces the burden on recipient government’s resources. However, no references could be found in the literature on the need to avoid inconsistency

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<sup>43</sup> Although tax administration and PFM generally, are themselves major sources of corrupt activities.

in a donor’s own programme of support e.g. their support to the government’s general PFM reform programme and their support to an education or health SWAp, which could also include financial management elements.

4.34 Studies in Malawi (Rakner *et al* 2004) and in Tanzania (Lawson and Rakner 2005) comment on the way prominent stakeholders perceive donors, as both undermining the legislative processes and lacking transparency in their dealings with the government. Stevens (2004) also highlights the need for donors to understand the incentives of aid, and the demands they make on governments to pursue their agendas. As with all organisations, donors have their own organisational culture and Witt and Müller (2006) and Bjuremalm (2006) refer to the need to understand the political economy of donors, as well as that of recipient governments. For example, a donor’s internal performance targets may emphasise money committed, which may not equate with the recipient government’s targets e.g. reform effectiveness. The question could also be asked as to whether separation of professional expertise (economists, accountants, procurement specialists) in a donor organisation, leads to the most effective guidance.

### Civil Society

4.35 The importance of civil society in PFM reform is now receiving significantly more attention both in the literature and amongst reformers generally. A literature review of recent research on PFM reform would therefore be incomplete without reference to their role in the overall process. In developed countries, they have been an active voice for many years; in developing countries amidst greater democratisation, civil society is becoming increasingly vocal.

4.36 A Civil Society Organisation (CSO) is generally separate from the state, has a non-profit dimension and either provides services to people (e.g. BRAC in Bangladesh) or lobbies government for reform, including greater accountability and wider PFM reforms (e.g. Institute for Democracy in South Africa (IDASA)) or does both (e.g. Oxfam). CSOs linked to PFM reform share a common agenda to make the budget process more inclusive, more committed to pro-poor choices and to provide independent oversight (Krafchick 2005). They

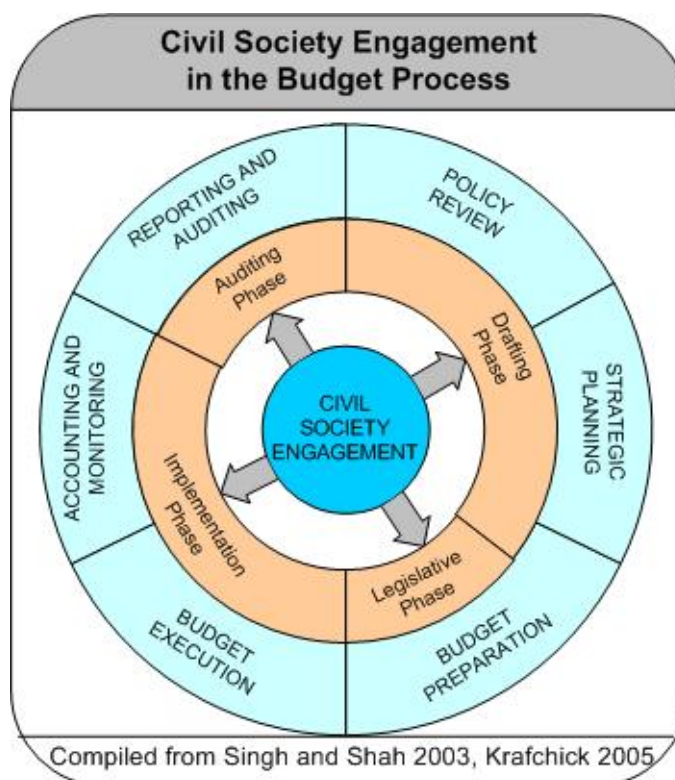


Figure 11 Civil Society Engagement in Budget Process

operate at various levels such as community level (e.g. Concerned Citizens of Abra for Good Governance (CCAGG) in the Philippines), national level (e.g. IDASA, Canadian Centre for Policy Alternatives (CCPA)), regional level (e.g. CABRI in Africa) and international level (e.g. IBP).

- 4.37 CSOs contribute to the PFM reform process through advocacy, training and capacity development. According to Krafchick (2005), CSO participation can benefit all four phases of the budget process (*Figure 11*). For example, in the drafting phase, CSOs in Porto Alegre Municipality in Brazil propose spending projects and set priorities. In the legislative stage, the Institute for Public Finance in Croatia make the budget easier to understand by producing simplified guides and discussion papers. The poverty hearings held by the South African National Non-Governmental Organisation Coalition, is an example of how a CSO is assisting in the development of the budget formulation process, through citizen consultation. Other CSOs also improve transparency by collecting, collating and disseminating budget information. Their independent analysis also supplements the research capacity of legislatures, the media and even the executive. CSO expertise provides a good foundation for training of other CSOs, the media and legislature, resulting in reforms that are more effective. In the implementation phase, the Centre for Budgets and Policy Studies in India, assist the legislature by monitoring actual expenditure against budget. CSOs have played a limited role in auditing reforms, although, there have been some examples where they have helped to strengthen the SAI. Mazdoor Kisan Shakti Sangathan (MKSS) in India monitor government development projects. During this social auditing process, public hearings are held and information, which is not always available through traditional auditing procedures, is exposed. Ramkumar and Krafchick (2005) also believe that CSOs can make a valuable contribution to PFM reform, by pressurising government to follow-up on the audit recommendations, as most SAIs do not have this power.

## **Summary**

- 4.38 *Country context:* PFM reform programmes need to be country-specific as they cannot be divorced from their historical, political and social heritage. For some authors, the importation of 'best practices' is a dangerous concept, without due consideration of local realities. In a post-conflict situation, the re-establishment of the overall framework for PFM and economic management is considered to be an important first step for sustainable peace as well as economic growth. In post-conflict countries, the IMF's three-step approach emphasises the centrality of the MoF and the need to establish simple rules and procedures. It also notes the need to use external technical assistance, at least in the immediate post-conflict period, although the World Bank questions the long-term sustainability of this approach.
- 4.39 *Capacity:* In developing capacity, the new guidance for donors is to build on existing capacity and not to impose external solutions. The lack of qualified personnel (accountants and economists) is identified as a major constraint for PFM reform in developing countries, but the availability of, and need for, broader management skills does not appear to have been evaluated. The sustainability of some PFM reforms (e.g. automated systems) also depends on the proper recognition of recurrent costs. Support to PFM reforms through regional

affiliations and peer-assisted learning groups is becoming increasingly popular. The comparative effectiveness of various forms of training (e.g. workshop, on-the-job training, mentoring) on the success of PFM reforms, does not appear to have been studied. Donor evaluations of technical assistance provided show that political leadership and clear strategic direction has increased success rates. They also indicate that proper attention needs to be paid to cross-cultural change management, for building support and interest for reform and long-term sustainability. The need to consider the broader cultural context is highlighted in PFM reform guidelines, but is recognised in only a few reform programmes. Interpersonal and change-management skills and a broad understanding of government processes and relationships, is seen as equally important as technical competency, when providing consultancy support.

- 4.40 *Service delivery:* Recent literature highlights the link between effective PFM systems and poverty reduction. Concerns are raised, as to whether sufficient attention is being paid to the service delivery perspective in current PFM reforms. In PFM reform programmes, led by the MoF, it is argued that the needs of the line ministries to achieve quality and efficiency in spending within and across programmes, receive less attention than the need to control overall government spending and to improve allocative efficiency. No evaluations appear to have been carried out to confirm or deny this perception, or to determine whether central PFM reforms have improved inter-governmental fund flows.
- 4.41 *External Stakeholders:* Recent literature emphasises the importance of civil society in all stages of the budget cycle and their role in promoting and monitoring PFM reform. The role of the media and private sector is also acknowledged, particularly in procurement reform and in the EITI; however, there do not appear to be many evaluations of their actual influence on PFM reform. The trend towards greater use by donors of partner country systems means that in aid-dependent countries, donors play a significant role in promoting PFM reform. The literature does highlight the need to understand the incentives of aid and the political economy of donors on PFM reforms, but no studies could be found on their impact.

## 5. Overall Summary and Topics for Evaluation

### Summary of Key Findings

- 5.1 *Definition:* There is no universally agreed definition of PFM. Definitions range from the narrow focus on the downstream activities of the budget process to a system of complex relationships, numerous role players and multiple dynamic processes. There is a realisation (in theory, if not always in practice) that PFM sub-systems are interconnected, so that changing one affects another.
- 5.2 *Monitoring and evaluation:* Until recently, assessment of PFM reform progress has been hampered by the lack of performance-based indicators. In developing countries, donor evaluations have frequently concentrated on their technical assistance, rather than the impact, relevance or sustainability of the reform itself. Other evaluations have often been based on observation and experience, rather than use of OECD evaluation criteria. This situation appears to be similar, irrespective of geographical region, although reform progress and support to sub-Saharan African countries' reforms, do seem to be more extensively monitored and evaluated.
- 5.3 *Realistic time scales:* Most of the PFM reform literature now agrees that PFM reform is a long-term endeavour, or even a continuing process of improvement. Progress assessments for HIPC show limited, but uneven progress and stress the need for realistic timescales. Unrealistic timescales were identified as one of the reasons for many PFM reform failures e.g. IFMIS implementations.
- 5.4 *Country context and ownership:* There is a steadily growing recognition that real reform cannot be imposed or bought. Political commitment and the support of senior management are essential if reforms are to be sustained. Consequently, reforms need to be sequenced and prioritised in the context of the country's own needs. The Strengthened and Platform Approaches to PFM reform attempt to address some of these issues. Post-conflict environments pose particular challenges, but also opportunities.
- 5.5 *Political, historical, social and institutional factors:* These factors have influenced the direction and speed of NPM and NPFM reforms in OECD countries, and although progress has been made, initial expectations have been downgraded. A key reason given for the lack of progress in MTEF and IFMIS implementation was the lack of attention to the political and institutional context. DoC and EUSM analysis attempts to understand the political context in which reforms take place. In all areas of PFM reform, there is a realisation that the required changes are not merely technical. Studies highlight the existence of informal practices, but rarely explain their emergence.
- 5.6 *Service delivery:* Recent literature has highlighted the importance of sound PFM systems to service delivery, poverty reduction and the achievement of the MDGs. There is concern in some of the literature that MoF managed PFM reforms are concentrating on the achievement of aggregate fiscal discipline and improvement at the centre, to the detriment of sector requirements.

- 5.7 *Links with other reforms:* Most evaluations highlight the importance of civil service and other reforms to the long-term sustainability of PFM reforms. Generally, PFM reforms in OECD countries have taken place alongside broader public service reforms.
- 5.8 *Change management:* Recent reform literature emphasises the need to consider change management issues in the design and implementation of reforms. In Bangladesh and Guatemala, establishing ‘bottom-up’ support for reforms was critical to their progress; however, there appears to be limited evidence of the use of broader change management methods, such as managerial coaching. In the Pacific region, recognition of different cultural values has also been important in designing capacity-building programmes, but this appears to be a rather isolated example.
- 5.9 *Capacity:* In developing capacity, the new guidance for donors is to build on existing capacity and not to impose external solutions. The literature highlights lack of professional skills, rather than managerial skills, as a serious constraint on PFM reform. Various training methods are used, but no studies appear to have been done on which is the most effective. However, peer groups and regional affiliations are becoming increasingly popular.
- 5.10 *External stakeholders:* Civil society and donors are increasingly active in promoting and supporting PFM reforms, while the media and private sector are seen as potential players. Recent evaluations show that greater donor harmonisation and coordination can have a positive affect on reform progress. Studies also discuss the need to understand the incentives of aid and the political economy of donors, but the impact does not appear to have been evaluated.
- 5.11 *Similar messages:* Several of the most recent studies appear to have very similar messages to those finalised five or ten years ago, particularly on the need to proceed slowly. This raises the question, as to why these lessons have not been implemented.

## **Suggested Evaluation Topics**

- 5.12 The literature suggests that more research needs to be done on the impact of tax administration issues on investment, doing business and state building. Potential alternatives to the PAC model, for the Caribbean (and SIDS generally) could also benefit from additional research. The Strengthened and Platform approaches are very new, and early evaluations are few or on-going, making it difficult to assign evaluation questions at this stage.
- 5.13 This review of the available literature has identified a number of knowledge gaps in ongoing reforms and/or interventions. A tentative list (below) of possible evaluation topics and suggested questions has been developed, in consultation with the management committee. The following provides a basis for future discussion:

- *PFM reform and service delivery* - Have the PFM reforms contributed to improved service delivery, through for example improved flow and predictability of funds at central government level? Have the PFM reform programmes and any sector reform programmes been mutually reinforcing or contradictory? Have PFM reforms resulted in greater predictability of fund flows and transparency for SN bodies?
- *PFM reform and civil service reform* - How have PFM reforms taken into account the status of other reform initiatives in their design and implementation?
- *Procurement reform* - What outcomes have been achieved so far? Is the playing field more equitable?
- *Payroll reform* - Has the introduction of new automated systems resulted in better controls and better information for medium term planning and budgeting purposes?
- *MTEF and IFMIS* - Have recent implementations been guided by earlier evaluations, or are the same mistakes still being made?
- *Legislative scrutiny* - Who has been the most effective in addressing legislative scrutiny issues, parliamentary networks, donors or other institutions? What techniques have proved the most effective, eg. links with other jurisdictions, workshops, regional affiliations, visits?
- *Drivers of change approach* - How has this been used in practice, both in the design and implementation of reforms, and what effect has it had on success rates?
- *Change management* - Has this really received the designated attention? To what extent have communication strategies been two-way not just one-way? Have the techniques used been sensitive to cultural differences e.g. hierarchical nature of society, form of consultation, spoken not written?
- *Donor coordination and harmonisation* - Has there been consistency within individual country strategies, thus reinforcing government PFM reform programmes or the reverse? Have organisational constraints e.g. separation of professional expertise (accountants, economists, procurement specialists) resulted in confusing messages for recipient governments?

5.14 In terms of prioritisation, it is suggested that each of the potential evaluation topics is rated against their 'impact' on, or relevance to, the following criteria: i) enhanced domestic accountability; ii) importance to the achievement of MDGs; iii) potential to reduce scope for corrupt activities; iii) long-term sustainability of reforms; iv) potential use of country systems by donors; v) knowledge gap identified in the literature; and vi) evaluation literature available.





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## ANNEX 1 : GLOSSARY OF COMMON TERMS

<b>Accountability</b>	Obligation to demonstrate that work has been conducted in compliance with agreed rules and standards or to report fairly and accurately on performance results vis-à-vis mandated roles and/or plans (DAC).
<b>Audit</b>	An independent, objective assurance activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to assess and improve the effectiveness of risk management, control and governance processes (DAC).
<b>Developmental risk</b>	The risk that developmental objectives are not reached. This is a crucial aspect in assessing whether to align with government systems or not. Developmental risk may point to using systems although fiduciary risk is high (Olander 2007).
<b>Direct Budget Support</b>	Development agencies increasingly provide financial support to macro-level policies and to government budgets to assist the recipient through a programme of policy and institutional reform and implementation that promote growth and achieve sustainable reductions in poverty. Direct Budget Support agreements are the formal DBS instruments negotiated between the development agency and recipient government.
<b>Evaluation</b>	<p>The systematic and objective assessment of an on-going or completed project, programme or policy, its design, implementation and results. The aim is to determine the relevance and fulfillment of objectives, development efficiency, effectiveness, impact and sustainability. An evaluation should provide information that is credible and useful, enabling the incorporation of lessons learned into the decision-making process of both recipients and donors.</p> <p>Evaluation also refers to the process of determining the worth or significance of an activity, policy or program. An assessment, as systematic and objective as possible, of a planned, on-going, or completed development intervention.</p> <p>Note: Evaluation in some instances involves the definition of appropriate standards, the examination of performance against those standards, an assessment of actual and expected results and the identification of relevant lessons (DAC).</p>
<b>Fiduciary Risk<sup>45</sup></b>	The risk that funds are not used for intended purposes, do not achieve value for money, or are not properly accounted for (DFID 2004).
<b>Fiscal Decentralisation</b>	Expenditure assignment, the transfer of funds, and/or tax-raising and/or borrowing powers from higher levels to lower levels in political systems (PEFA 2008).

<sup>45</sup> Currently, there is no standard definition of this term; work is ongoing to agree a standard definition.

<b>Heavily Indebted Poor Countries (HIPC)</b>	First launched in 1996 by the IMF and World Bank with the aim of ensuring that no poor country faces a debt burden it cannot manage. The initiative entails coordinated action by the international financial community, including multilateral organisations and governments, to reduce to sustainable levels the external debt burdens of the most heavily indebted poor countries (Olander 2007).
<b>Internal Audit</b>	Internal Audit includes references both to assurance and to consulting activities directed at the governance, risk management and internal control processes of an organization (Institute for Internal Auditors).
<b>Internal Control</b>	<p>Internal control is an integral process that is effected by an entity's management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the entity's mission, the following general objectives are being achieved:</p> <ul style="list-style-type: none"> <li>▪ executing orderly, ethical, economical, efficient and effective operations;</li> <li>▪ fulfilling accountability obligations;</li> <li>▪ complying with applicable laws and regulations;</li> <li>▪ safeguarding resources against loss, misuse and damage.</li> </ul> <p>(INTOSAI guidelines on internal control standards - revised 2004)</p>
<b>Medium-Term Expenditure Framework (MTEF)</b>	Forward medium-term (typically three to five years) estimates of the costs (integrating recurrent and capital spending) of existing policies and proposed policy changes subjected to explicit aggregate fiscal ceilings (Olander 2007).
<b>Performance budgeting (direct)</b>	This involves allocating resources based on results achieved. This form of performance budgeting is used only in specific sectors in a limited number of OECD countries. For example, the number of students who graduate with a Master's degree will determine the following year's funding for the university running the programme (OECD 2008c).
<b>Performance budgeting (informed)</b>	Resources are indirectly related to proposed future performance or to past performance. The performance information is important in the budget decision-making process, but does not determine the amount of resources allocated and does not have a predefined weight in the decisions. Performance information is used along with other information in the decision-making process (OECD 2008c)
<b>Performance budgeting (presentational)</b>	It simply means that performance information is presented in budget documents or other government documents. The information can refer to targets, or results, or both, and is included as background information for accountability and dialogue with legislators and citizens on public policy issues. The performance information is not intended to play a role in decision-making and does not do so (OECD 2008c).
<b>Sector Budget Support</b>	Financial support from a development partner that is channelled into the general treasury account of a recipient country where, as an integral part of the resources herein, it co-funds the national budget, but dialogue and follow-up focuses on the sector (Olander 2007).
<b>Sector Wide Approach (SWAp)</b>	A programme-based approach operating at the level of an entire sector (DAC).

## ANNEX 2: ASSESSMENT TOOLS – PFM REFORMS AND SYSTEMS

**Country Financial Accountability Assessment (CFAA):** The CFAA is not an audit of a country's financial management system, nor does it define minimum standards for system capabilities and performance. It reviews the status of public and private sector accounting (some) and auditing. CFAAs did provide recommendations and action plans. CFAAs focussed on describing and analysing downstream financial management and expenditure controls, including expenditure monitoring, accounting, financial reporting and internal controls.

**Country Policy and Institutional Assessments (CPIA):** The CPIA assesses the quality of the country's current policy and institutional framework. The World Bank carries out the assessment and uses the ratings to guide its allocation of IDA resources to recipient countries. The set of criteria used for the CPIA ratings are grouped into four clusters. The fourth cluster "D" relates to public sector management and institutions. Questions 13 on the quality of budgetary and financial management, 14b on tax administration and 16 on transparency, accountability and corruption in the public sector are closely aligned to various PEFA indicators. Although, on differing types of scales both indicators sets (CPIA and PEFA) are calibrated. Where PFM assessments have been undertaken using the PEFA Framework, they are being used to support the scoring of the CPIA ratings.

**Country Procurement Assessment Report (CPAR):** The World Bank introduced CPARs in the mid eighties to assess whether procurement rules and practices of borrowing governments conformed with Bank requirements; however, their emphasis evolved from assessing procurement arrangements in relation to Bank financed projects to assessing national and sub national procurement laws regulations, and procedures (Allen *et al* 2004). Since 2006, the CPAR has been replaced by the methodology for the assessment of national procurement systems (see below).

**Debt Management Performance Measurement Framework (DeMPA):** The DeMPA framework launched in 2007, follows closely the principles and methodology of the PEFA Framework, but is focused exclusively on debt management. It therefore represents a drill down of PEFA indicator PI-17 into a detailed set of 15 indicators. These 15 indicators review issues in relation to: i) governance and strategy development; ii) coordination with macro-economic policies; iii) borrowing and related financing activities; iv) cash flow forecasting and cash balance management; v) operational risk management and vi) debt records and debt reporting.

**Fiduciary risk assessments:** DFID Fiduciary Risk Assessment is designed to assess and record fiduciary risk in relation to its budget support operations. This instrument used a set of 15 benchmarks or indicators, covering the fiduciary risks associated with PFM systems, together with a narrative that included the risk of corruption. DFID's indicators were rated on a 3-point ordinal scale similar to the HIPC expenditure tracking indicators and the level of indicator aggregation was also similar. With the launch of the PEFA Performance Measurement Framework, DFID is replacing its internal guidance on conducting fiduciary risk assessment, so that - where available - PFM assessments based on the PEFA indicator set now constitute the foundation for DFID's fiduciary risk assessment. The additional element of anti-corruption assessment, however, is still maintained by DFID in its guidelines. Internal guidelines of several other bilateral donor agencies (e.g. France, the Netherlands, Sweden and Denmark) have recently been updated to refer to the PEFA indicator set as the preferred basis for assessing performance of PFM systems in client countries

**Framework for Cash Transfers to Implementing Partners:** Utilised by the UNDP group in support of the harmonisation of cash transfers, this assessment is divided into two components; a macro assessment of a country's public financial management system and a micro assessment of implementing partners' financial management capacity. The macro assessment is based on a PEFA assessment where available.

**Methodology for assessment of national procurement systems:** The **Baseline Indicators** (BLIs) also referred to as the Baseline Indicator System (BIS): The baseline indicators have been developed as part of a collaborative effort by the World Bank/OECD-DAC Procurement Round table initiative on strengthening procurement capacities in developing countries. The tool is based predominantly on 12 macro indicators designed to examine key elements of a public procurement system under four pillars. Pillar I. Legislative and Regulatory Framework 1. Procurement legislative and regulatory framework complies with applicable obligations deriving from national and international requirements; 2. Availability of implementing regulations, documentation and tools to support implementation. Pillar II. Institutional Framework and Management Capacity 3. Degree of mainstreaming and integration into Public Financial Management System; 4. Existence of a Functional Management/Regulatory Body; 5. Existence of Institutional Development Capacity; Pillar III. Procurement Operations and Market Practices 6. Efficiency of Procurement Operations and Practices; 7. Functionality of the Public Procurement Market; 8. Existence of Contract Administration and Dispute Resolution Provisions; Pillar IV. The Integrity of the Public Procurement System 9. Existence of Effective Control and Audit Systems; 10. Existence and Efficiency of the Appeals Mechanism; 11. Degree of Access to Information; 12. Existence of Ethics and Anti-corruption Measures (OECD 2006). “The BLIs present a “snapshot” comparison of the actual system against the international standards that the BLIs represent” (OECD 2006:3). The **Compliance/Performance Indicators** (C/PI): These deal with how the system actually operates and reviews what is happening on the ground by examining a sample of procurement transactions. Suggested C/PI for relevant BLI indicator/sub indicators are contained in the OECD manual guidelines (OECD 2006).

**OECD Aid Effectiveness Indicators:** The 56 partnership commitments are organized around the five key principles: Ownership, Alignment, Harmonization, Managing for Results, and Mutual Accountability. The Declaration is supported by a set of 12 “Indicators of Progress” on aid effectiveness, which were developed as a way of tracking and encouraging progress against the broader set of partnership commitments, that improves transparency and accountability on the use of development resources. Under the Paris Declaration Principle of “Alignment”, Progress Indicator 2(a), which deals with public financial management system, is closely linked to the PEFA framework. The Paris Declaration Progress Indicator 5 is closely aligned to the PEFA Performance Indicator D-3 whilst the Indicator 7 is closely linked to the PEFA D-1, D-2 and the second (ii) dimension of PI-7.

**Public Expenditure Review (PER):** Until the nineties, traditional PERs consisted mainly of an assessment of fiscal trends, an analysis of resource allocations between and within sectors. Various annexes deal with expenditure policies and programmes in the major sectors and sometimes a review of the fiscal relationship between government and public enterprises. Since the start of the twenty first century PERs have increasingly added budget systems, implementation, and capacity building to their areas of review The main emphasis is on the upstream phases of medium-term expenditure programming, annual budget preparation and legislature approval of the budget. In Tanzania, the PER process has evolved from being an external assessment of expenditure management to part of the budget process with a wide range of stakeholders (Allen *et al* 2004).

**PFM Performance Measurement (PEFA) Framework:** The PEFA Framework was developed against the background of the need to: i) reduce on the heavy transaction costs on recipient governments; ii) reduce on the overlap of the many diagnostic instruments; iii) improve and enhance coordination among donors and iv) improve on the impact of reform initiatives. The PEFA Framework provides a “snapshot” of a country’s PFM performance system. It covers the entire financial management cycle and embraces international standards and codes in its structure. The framework is based on a set of 28 evidence-based indicators in terms of the government and three indicators in relation to donor practices.

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**Public sector accounting and auditing – a framework for comparison to international standards:** This diagnostic tool has been designed by the World Bank and tested in South Asia Region countries. It has been designed to assist countries in assessing how well their public sector accounting and auditing standards accord with the relevant international standards.

**Report on the Observance of Standards and Codes (ROSC) (fiscal transparency):** A Fiscal ROSC is based on the IMF's code of good practices developed in 1998 and revised in 2001. The code is intended to apply to all IMF countries but participation is voluntary. The assessment is carried out by IMF staff and is based on the four key requirements of fiscal transparency, clear roles and responsibilities, full provision of information, open budget preparation and execution and assurances of integrity.



Strong Public Financial Management (PFM) systems are essential to improved service delivery, poverty reduction and to achievement of the MDGs. Effective PFM systems maximise financial efficiency, improve transparency and accountability, and – in theory – will contribute to long-term economic success. Activities range from the preparation and fulfilment of the budget cycle, budget oversight and control, taxing and debt management and procurement, to resource allocation and income distribution, and are increasingly seen as a set of inter-related sub-systems (and organisational and political cultures), rather than a stand-alone activity.

This literature review aims to synthesise the main theoretical approaches and findings from evaluations of PFM reform programmes, and to identify knowledge gaps. The literature reviewed includes academic and technical articles, development practitioner guides, manuals, handbooks and websites. A multi-donor evaluation examining how to strengthen PFM in (and with) partner countries is planned for 2009, and this literature review will feed into that process.

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