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Diagnosis and Reform of Public Financial Management Systems: a Key Cross-cutting Issue for Program-based Approaches in Development Policy

In recent years public budgets have become an increasingly prominent issue in the international development debate. For one thing, more and more countries are developing poverty reduction strategies (PRS) or similar national development agendas that need to be translated into medium-term planning and allocation decisions, which in turn have to be implemented via the annual budget. For another, program-based approaches (PBAs), which primarily make use of recipient countries' own systems and procedures to manage donor funds, are assuming more and more importance in international development cooperation. The risks associated with budget support and other forms of PBAs hinge in crucial ways on the quality of partner countries' public financial management (PFM) systems.

PFM systems in most developing countries are marked by substantial shortcomings. As a consequence, donors have developed a large set of diagnostic tools to assess PFM systems in developing countries. These tools are, however, beset by a variety of overlaps and omissions that tend to overstrain scarce capacities among both donors and partners and impact negatively on the quality of the diagnostic work undertaken. In addition, the predominantly donor-driven analyses of PFM systems focus primarily on the assessment of fiduciary risks related to different forms of PBAs and most of the time provide little indication as to the formulation of coherent and sustainable reform strategies.

In the Paris Declaration on Aid Effectiveness both donors and recipient governments have committed themselves to developing common frameworks for assessing PFM systems and to systematically integrating these frameworks within partner-led reform and capacity-building strategies. Under the Public Expenditure and Financial Accountability Program (PEFA), several donors have been involved in developing just such a common framework to assess and reform PFM systems in developing countries. Effective and sustainable PFM reform, however, constitutes a considerable challenge for all parties involved. PFM systems are highly path-dependent, and reforming them is first and foremost a political task. Effective reform strategies therefore require strong commitment by all stakeholders, maintenance of momentum for reform over a protracted period of time, a large measure of partner ownership for the reform process, and a willingness on the part of donors to work for extensive coordination, harmonization, and division of labour.

The relevance of PFM for development

Public budgets have in recent years become an increasingly prominent issue in the international development debate as more and more developing countries are formulating ambitious PRS or similar national strategies and reform agendas that need to be translated into concrete medium-term policies and programs, which in turn have to be implemented through annual budgets. Budgets serve to set political priorities for or against public spending for basic social services or, for example, military spending or public-sector employment. The efficiency and effectiveness with which these priorities are taken forward is itself determined by the formal as well as informal institutional and procedural set-up determining strategic planning, budget formulation, execution, and control processes. The systems in place to manage public finances in developing countries are therefore of crucial importance in achieving the Millennium Development Goals (MDGs). In addition, good PFM, characterized by transparency and effective oversight and accountability, is closely linked with development objectives such as participation, governance, and democratization.

At the same time, a far-reaching reorientation of international development cooperation is currently underway. With the MDGs (Goal 8), the Monterrey Conference and the corresponding harmonization agenda, and, most recently, the Paris Declaration on Aid Effectiveness, donors have committed themselves to improving the quality of their aid by aligning it more closely to partner programs, systems, and procedures, in particular their planning and budgeting cycles. Joint donor approaches such as sector-wide approaches (SWAps), general and sector budget support, and other PBAs geared to supporting partner strategies and programs primarily by using existing government systems and procedures are therefore gaining increasing currency in the discussion and, albeit slowly, also in the practice of development cooperation. Both their effectiveness and the risks these approaches entail hinge in crucial ways on the quality of PFM systems in recipient countries and the ability of governments to ensure that the funds provided are put – effectively and efficiently – to the uses for which they are intended.

Public financial management in developing countries

PFM systems in most developing countries for which PBAs are of actual relevance are marked by serious deficits, in particular with regard to budget comprehensiveness and realism as well as to transparency and accountability in budget execution. Among the most prominent reasons for these shortcomings are insufficient human and technical capacities, inappropriate budgeting systems and classifications as well as corruption and lack of political commitment to transparent and poverty-oriented management of public funds.

Not least as a result of the great interest taken in these issues by the Bretton Woods institutions, the formal rules and procedures that ostensibly govern the management of public funds in many developing countries are nowadays mostly in line with international standards and good practices, as stipulated for example in the International Monetary Fund's (IMF) *Code of Good Practices on Financial Transparency*. In principle, therefore, these systems should be well-suited to delivering realistic medium-term and annual budget plans in line with political priorities, e.g. from a PRS, reconciling these priorities with the available resource envelope, and ensuring the orderly and regular implementation of the budget. Frequently, however, the formal institutional set-up of the budget process in developing countries has little relevance for actual PFM practices, which often are determined by informal institutions and procedures that undermine budgetary discipline and the implementation of strategic priorities (see box, below).

Formal and informal PFM institutions in Malawi

Malawi can serve as a typical example of PFM systems in heavily donor-dependent countries in sub-Saharan Africa. Not least due to strong donor influence, the formal PFM institutions and procedures in Malawi are in principle well-suited to ensure that the national budget is realistically planned, implemented as approved, and effectively monitored. However, lack of technical and human capacities and deficient incentive systems in public administration combined with the failure of Malawian civil society to hold government accountable, inconsistent donor behaviour, and – above all – lack of political will and commitment to sound PFM have meant that these formal rules have little or no relevance for actual PFM practice. In the past this has again and again led to substantial discrepancies between approved and actually executed expenditures, sometimes amounting to 40 % and more. More than half of Malawi's public institutions regularly received either 10 % less or 10 % more than originally programmed, and it used to be not uncommon for institutions to receive allocations 30 % higher or lower than originally anticipated.

Sources: Fozzard / Chauncey 2002; DFID 2004

Deficiencies in the management of public finances may impact in many different ways on the ability of governments to translate their political priorities into policies, budgets, and, ultimately, the delivery of public services. As a consequence, even governments with a strong commitment to sound PFM and effective poverty reduction may find it difficult if not impossible to spend public resources in keeping with strategic priorities, and thus to implement national strategies such as a PRS. Where governments lack the necessary technical and human capacities, the complex tasks involved in translating strategic goals and objectives into medium-term plans and annual budgets are practically beyond their means; the resulting lack of budget realism in combination with inadequate control systems and capacities lead to significant discrepancies between approved budget figures and actual spending in many developing countries. This is of particular relevance in the social sectors education and health, which are generally regarded as key sectors with regard to poverty reduction.

Such weaknesses in PFM systems are further exacerbated by the fact that most developing countries are highly dependent on external factors for financing public expenditures. Factors such as climatic influences, developments in international markets, and, in particular, donor behaviour can severely undermine governments' ability to plan realistically for resources actually available over the medium and short term. Especially their heavy dependence on international donors poses major problems in terms of predictability of funds and budget comprehensiveness; moreover, unharmonized planning cycles and donor procedures for the management of funds and inconsistent reporting requirements constitute an additional burden on the scarce capacities of recipient countries' administrations.

Finally, the quality of a country's PFM system itself directly impacts on the availability of external funding for the implementation of national development strategies. Lack of planning and implementation capacities as well as inadequate internal and external budget control mechanisms increase the fiduciary risks related to the provision of budget support. The willingness of donors to provide budget support to a particular country, however, hinges in large measure on their assessment of the risks involved. Diagnosis and reform of PFM systems in developing countries is therefore a core task of cooperation between donors and partner countries within the framework of PBAs.

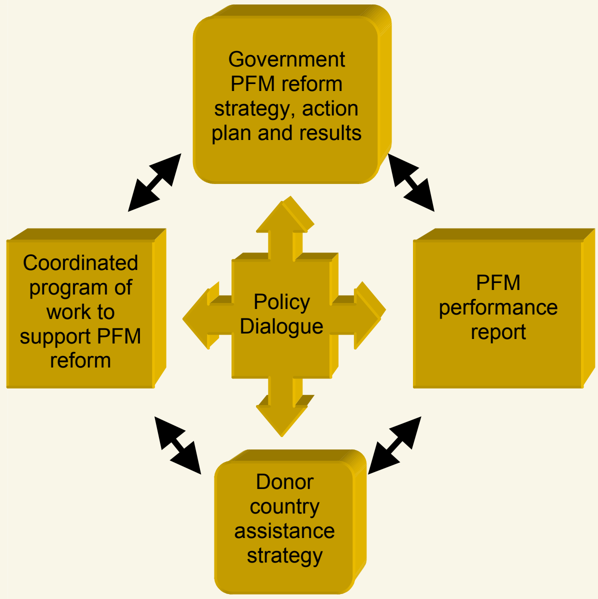
A strengthened approach to assessing PFM: PEFA's Performance Measurement Framework

In order to realistically assess the fiduciary risks associated with the provision of budget support and related financing instruments in a particular country context, a number of donors, in particular the IMF and the World Bank, have developed a broad array of diagnostic instruments (see Leiderer 2004). Even though this set of tools covers a large range of important areas of PFM, it has, for a number of reasons, attracted increasing criticism. One of the main criticisms is that the individual instruments are poorly harmonized and that there is little coordination of the diagnostic work conducted, a fact that in the past has led to significant duplications of work and subsequent burdens on scarce partner administrative capacities. As a consequence, partner countries often find themselves confronted with a plethora of uncoordinated and in part incompatible recommendations intended to improve their PFM systems.

Furthermore, the somewhat lopsided focus of most donors on the assessment of risks inherent in partner countries' PFM systems tends to disregard the partner governments' own interests in the analytical work conducted, a circumstance that may severely undermine partner ownership for the assessment process and thus impact negatively on the quality of the analysis. But above all, the predominantly donor-driven assessments of PFM systems for the most part fail to provide meaningful indications on the development of viable approaches to the formulation of comprehensive and sustainable reform strategies designed to improve PFM in specific country circumstances. One reasons for this, however, is that, despite the large set of different diagnostic tools, a number of important subareas of PFM are largely neglected in the analyses conducted. These areas include in particular the revenue side of the budget, financial management at subnational levels, and politically sensitive areas such as security and defence budgets.

In response to the growing criticism, the World Bank, the European Commission, and the British Department for International Development (DFID) in 2001 initiated the Public Expenditure and Financial Accountability (PEFA) Program, since joined by a number of other donors. Its aim is to strengthen recipients and donors in their ability to realistically assess PFM systems and to develop practicable approaches for sustainable reforms as well as the capacities needed to implement them. The approach proposed by PEFA is that of a coordinated, sequenced program of diagnostic and capacity building work agreed on between recipient governments and development agencies and based on an extensive policy dialogue. This *Strengthened Approach to PFM Reform* is based on a largely standardized *Performance Measurement Framework* which incorporates a set of 28 high-level performance indicators, the IMF Fiscal Transparency Code and other international standards. It is designed to assess risks and identify weaknesses in PFM systems in a comprehensive, transparent, and comparable way. This assessment forms the basis of a *PFM Performance Report*, which is set to replace most of the analytical tools presently in use. The assessment – conducted jointly by donors and government – is designed to take into account the information needs of donors and partner governments alike. In-depth analytical and advisory work in areas where weaknesses have been identified is then to be undertaken through a joint program of work led by the recipient government, which requires donors and partner governments to engage in an intensive policy dialogue to reach agreement on a joint PFM capacity-building and reform program (see figure, below).

PEFA's *strengthened approach to PFM Reform*



Source: Smithers 2004, modified

PFM reform: a joint responsibility…

In the Paris Declaration on Aid Effectiveness, donors and partner governments have committed themselves to implement harmonized diagnostic reviews and performance assessment frameworks in public financial management, such as the PEFA approach, that provide reliable assessments of performance, transparency, and accountability of country systems. Furthermore, they agreed to integrate their diagnostic reviews and performance assessment frameworks within country-led strategies for capacity development and to undertake and harmonize support for necessary PFM reforms.

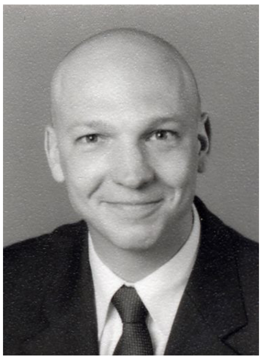
The task of formulating and implementing effective PFM reform agendas constitutes a considerable challenge for donors and partner governments alike. PFM systems are highly path-dependent, and solutions that prove successful in one particular country may not necessarily be appropriate in different circumstances. To be sustainable, PFM reforms must take a holistic approach, i.e. at all times take the PFM system as a whole into account. Isolated measures addressing specific weaknesses of the PFM system need to be carefully coordinated with parallel reform steps and aligned with existing PFM elements as well as with the overall government system. Otherwise well-intended measures and reform steps may in fact tend more to undermine than to strengthen the overall PFM system, implanting incompatible elements into the system or diverting capacities from other vital PFM functions. This is particularly relevant because donors tend to base their proposed solutions to specific PFM problems on the systems in place in their own countries. These, however, differ substantially in many respects and are frequently all but incompatible. Effective donor coordination and harmonization is therefore a key prerequisite for successful PFM reform.

In addition to this, PFM reform is a highly political matter that touches upon a good number of donor and partner interests. For this reason, what is required for reform efforts to be successful is a high degree of ownership and consistent alignment of donor activities to partner programs and strategies. In particular, the development of adequate PFM capacities must be viewed as an endogenous process that cannot be undertaken from outside but must be fully owned by partner governments and merely supported by donors. The initial phase of a sustainable reform process must therefore be concerned in particular with the creation of political will and a mandate for the stakeholders involved, above all on the partner side, while ensuring that the first reform steps taken are neither overly complex in technical terms nor too capacity-intensive. Accordingly, PFM reform must be regarded as a long-term process, for which some scholars consider 15–25 years to be a realistic timeframe. The identification and careful sequencing of appropriate reform platforms is essential to sustain the momentum for reform among all stakeholders over such a protracted period of time, without relinquishing the ability to quickly implement individual measures that might prove necessary in the short term. Donors and governments must therefore develop joint programs of work without losing sight of the impacts individual measures may have on existing capacities. The "right" sequence of reform platforms, however, hinges in large measure on the specific circumstances encountered in a particular country.

… and a challenge for donors

The task of realistically assessing their PFM systems and undertaking effective reforms places great demands on capacities of governments in developing countries. However, for donors as well, sound analytical work, policy dialogue, and support for reforms amount to a complex task that requires extensive technical expertise and human resources on the ground. Even the multilateral donors, despite their undisputed dominance in this field, are unable to master this task on their own. Therefore, what is called for apart from additional efforts to strengthen the expertise of individual donor agencies on PFM issues, is a strong commitment to closer collaboration between donors. Joint donor approaches of the kind provided for by the PEFA approach thus point in the right direction. By agreeing on a joint program of work in support of PFM diagnosis and reform that can be adopted by all stakeholders and which provides for a meaningful division of labour, donors are able to embark on an intensive policy dialogue with partners in all relevant subareas of PFM without overstraining their own scarce capacities on the ground. Viewed against this background, it may prove wholly reasonable for smaller bilateral donors to provide relatively small contributions to budget support to "buy in" to the relevant forums for policy dialogue and donor coordination groups, where they may then take charge of individual PFM areas and operational activities.

Joint approaches to PFM work however, require a large measure of donor coordination and a willingness to adapt the conceptual underpinnings and modes of delivery of their support, for instance by pooling technical assistance to support partner-led reforms and by more closely dovetailing financial and technical assistance. Joint approaches also imply that to improve the effectiveness of their contributions, individual donors must be prepared to eventually accept reduced "visibility" of their assistance.



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