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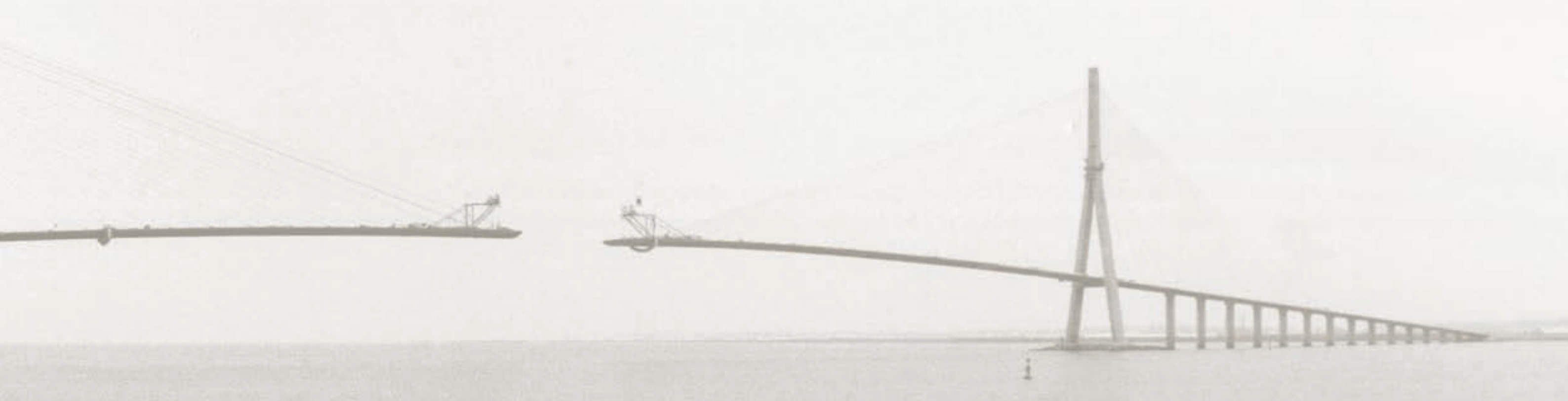


Briefing Paper 3/2011

Reforming Public Financial Management Systems in Developing Countries as a Contribution to the Improvement of Governance

Summary

How does reforming public financial management (PFM) help to improve governance in developing countries? In both industrialised and developing countries PFM reforms affect fundamental interests of state and governance. Although PFM has steadily grown in importance in development cooperation in recent years and such donors as the United Kingdom and Germany are increasing their engagement in this respect, PFM reforms – such as the strengthening of national audit offices and the introduction of IT-assisted financial management systems – are still not seen as a separate area of activity, but frequently from the narrow angle of improving technical efficiency. For PFM reforms to succeed, however, it is vital that their effects on governance are taken into account.

The increased use of modern development cooperation approaches based on the Paris Declaration principles has led to an interest being taken in the quality and efficiency of PFM systems that goes well beyond a direct interest in preventing corruption. Above all, standardised assessment tools have made it possible for the quality of PFM systems to be measured systematically in many developing countries and for more targeted reform programmes to be implemented. However, the contribution made by PFM reforms to the improvement of governance is often underestimated. Four basic dimensions of governance benefit from PFM reforms:

- A functioning system of PFM makes actors more accountable to the parliament, the national audit office and the public.
- Established PFM structures encourage the separation of powers by seeking to build institutions that are based on a division of labour and equipped with control mechanisms.
- PFM reforms help to improve transparency by generating information, by networking sources of information and by making them accessible, this also being a prerequisite for crucial governance reforms, such as decentralisation processes.
- PFM processes improve the effectiveness and efficiency of government action and so increase the state's legitimacy.

The following conclusions can be drawn: first, it is important to promote such "pioneering institutions" as national audit offices to narrow the gap between *de jure* and *de facto* reforms. Second, the principles called for in the context of PFM reform programmes, such as the transparency of budgets and open tendering and procurement procedures, must also be reflected in development cooperation programming itself. Third, PFM reform programmes should be guided by the country's need for reform rather than any fiduciary requirements donors may have. Fourth, development cooperation should be so designed that any adverse effects it may have on governance in developing countries – such as the poaching of qualified government staff for donor projects – are kept to a minimum.

In both industrialised and developing countries PFM is a core dimension of governance. It concerns budgetary institutions and procedures, such as parliamentary budget committees, independent audit offices and budget planning processes. Technically speaking, the goal of PFM reforms is therefore more transparent, more effective and more efficient handling of government spending.

PFM reforms are relevant to donors for the following reasons:

- As the **main instrument for the effective and efficient implementation of poverty-reduction and sectoral strategies:** Effective policies – regardless of the sector concerned – are hardly conceivable in practice without adequate PFM standards.
- As **entry points for joining the governance dialogue:** PFM reforms are instrumental in entering into a dialogue on basic governance issues with partner governments at a technical level (and then at a political level, too) and to translate them into practical activities.
- As a **means of reinforcing the financial control mechanisms:** PFM reforms are used to prevent abuse and corruption, which may otherwise undermine the credibility of development cooperation programmes (reputation risks).
- As a major **prerequisite for modern development cooperation approaches** using national PFM systems: Implementation of programmes by developing countries themselves can often help to strengthen their ownership of the reform process rather than it being undermined by the use of parallel donor systems and mechanisms.

Similarly, functioning PFM systems are vital for developing countries. They are needed (a) to implement policies in all sectors and the national budget effectively and efficiently; (b) to attract additional donor resources that use national mechanisms; (c) to give domestic and foreign investors confidence and (d) to gain better access to the capital market.

While PFM was viewed primarily in the narrow terms of combating corruption in the 1990s, the Paris Declaration on Aid Effectiveness, with its commitment to the greater use of national (PFM) systems, sent out a particularly strong message. Budget support is often one of the main points of departure for dialogue on PFM issues. Where donors use budget support to finance major reform programmes (usually poverty alleviation strategies), while taking advantage of national systems, attention turns to the quality and efficiency of these systems. Budget support primarily assists countries that are willing to reform their PFM systems or helps to trigger such processes in partner countries.

The growing international interest in recent years has also been accompanied by the further development of analytical instruments for assessing PFM systems. Besides the many specific analytical approaches (for assessing public procurement, for instance), the *Public Expenditure and Financial Accountability* (PEFA) assessment framework has established itself as an internationally renowned analytical tool since 2005. Being a standardised approach, PEFA enables a good overview of trends to be obtained at comparable intervals (as a rule, every three to five years) and, on the basis of 28 indicators, it also provides information on all relevant areas of PFM; increasingly, separate PEFA assessments are also being carried out for the subnational level.

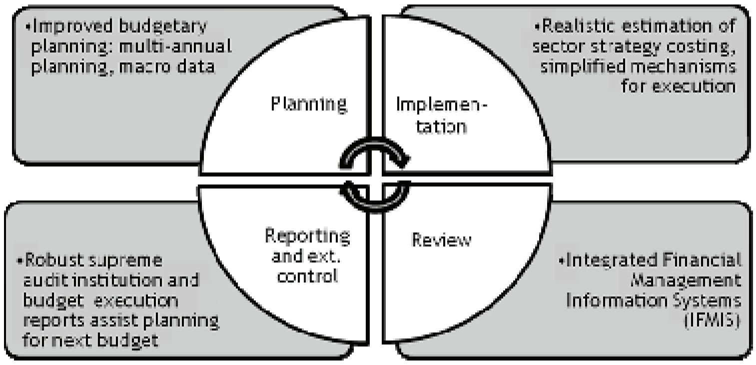
Analyses show that the efficiency of PFM systems in developing countries varies. Eastern Europe and Latin America, for example, generally do better than the MENA region. In sub-Saharan Africa, where most PEFA studies have so far been undertaken, such countries as Burkina Faso and Mauritius are at the upper end of the PEFA scale, while the situation in other countries, such as Gabon, is often unsatisfactory. Reform candidates in Africa can therefore be divided into various efficiency groups; while countries whose PEFA result is good on the whole must, above all, continue to work on improving budget execution and control (downstream processes) and practical application (*de facto* reforms), less advanced countries are also found wanting when establishing their budgets (upstream) and in legal and institutional terms (*de jure*). An important finding is that high domestic revenue, political stability, growth and continuous reform efforts have a significant, positive influence on the quality of PFM systems.

What precisely is it that links PFM reforms and governance? PFM systems are closely associated with governance issues. For one thing, they are themselves core components of governance. In the analysis of governance (using, say, the World Bank's *Worldwide Governance Indicators*) public financial management systems play a central role, since they are an essential part of government action. The following four effects of PFM reforms on governance are the most important:

(i) Accountability: PFM helps to improve the chances of institutions and persons working in them to be held to account politically for their actions or their inaction (through the application of clearer efficiency criteria to governments, for example) or, in a narrower sense (in the event of misconduct, corruption, etc.), to be held judicially liable. Accountability extends, for example, to the question whether resources have been used in accordance with the political priorities. In this way, functioning PFM systems encourage political accountability. A lack of awareness that office-holders can be subjected to control mechanisms of this kind is often prevalent in African societies. In this respect, such events as "accountability days," at which local authorities disclose their revenue and how it is spent, can contribute to the establishment of simple, but effective structures for accountability.

(ii) Separation of powers: Functioning PFM structures strengthen a system in which powers are separated. They are based on control mechanisms and a division of labour among institutions. Parliaments, governments and audit offices thus perform tasks which are fundamentally different, but complementary in that these bodies monitor each other through checks and balances. Functioning PFM systems cannot manage without this division of labour, and as reforms are geared to ensuring the independence of each actor, they are not only "purely technical." In effect, political systems of an autocratic nature expose themselves to "democratisation risks" by supporting PFM reform agendas.

Figure 1: The budget cycle and entry points for PFM reforms



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In countries that are heavily dependent on external financial aid, donors take the place of national PFM systems in some ways and may undermine independent tendencies – as when donors perform control functions more effectively than the country's parliament or national audit office. It is precisely when development cooperation is used outside national structures that it may have adverse effects on the governance system.

(iii) Participation and decentralisation: PFM systems rely on transparency since they are based on the networking of information, without which they cannot be fully utilised. When a country's citizens, civil society groups and media are able to recognise the government's spending priorities from a transparent budget, one requirement for opinion-forming and participation in political processes is met. Although democratically legitimised leadership structures are not automatically to be found in countries with workable PFM systems, PFM support can contribute to greater participation. In fact, not all PFM reforms are necessarily accompanied by a democratic process of openness. Singapore and Ethiopia are examples of relatively autocratic regimes with comparatively well functioning PFM systems. Nonetheless, the efficient provision of services by the state often sets in motion a process of exchange between government and citizens that leads on to increased participation and transparency.

Participation is not confined to the level of central government. Serious processes of (fiscal) decentralisation, too, require minimum PFM standards, first, because any transfer of authority and representation to local level depends on appropriate resources being made available and then used responsibly. Second, there is frequent and considerable distrust of local structures at national level in many developing countries. This may be due to aspects of political loyalty and central government's claim to power, but the ability of local structures to use financial resources appropriately also plays its part. In this respect, too, functioning PFM structures at local level can open the way to decentralisation processes.

(iv) Effective government action: PFM systems increase the effectiveness and efficiency of government action and help to consolidate the legitimacy of the state, which is often marred by corruption and inefficiency. PFM reforms have an impact throughout the budget cycle (see Figure 1). When the budget is being established, PFM systems are responsible for ensuring that political priorities are matched by adequate appropriations; when it comes to spending, they see to it that the financial allocation and needs concur as far as possible. Parliamentary budget committees, finance ministries and audit offices are tending to become stronger in this process. In many countries weak PFM systems result in only some (in extreme cases, only about 50 per cent) of the budget allocated effectively being executed. The key problem here – besides capacity constraints in the procurement system – is weaknesses in budget planning, which reduce the benefits derived from efforts to alleviate poverty. Unscheduled spending of budget resources, at the end of the financial year, for example, to avoid the future reduction of allocations, is usually neither effective nor efficient. Lastly, in the reporting phase the information gap is closed by functioning PFM systems, which is essential for accountability. World Bank studies suggest that strengthening accountability can prevent corruption more effectively in the long run than the development of short-term parallel structures for project implementation. In this way, effective PFM systems help to build trust between the state and its citizens and among international investors and donors.

There are various reasons for the fact that changes to PFM systems often take time and can only be achieved incrementally. Clientelist systems have no interest in reforms, since workable PFM mechanisms would question their very existence. PFM reforms tend to pose a threat to authoritarian systems, especially when the latter are far from being development-oriented. The political willingness of the governments concerned is the decisive precondition for effective PFM reforms. Rhetorically at least, government representatives must devote themselves to a reform agenda, although its implementation is sometimes fragmentary. Internal interests in the partner countries vary in this respect. Within governments the role of finance ministries and the influence they can wield over policy-making are strengthened by PFM reforms, while the role of sector ministries is weakened. It must also be borne in mind that even in countries pursuing a serious PFM reform policy its implementation can proceed no more than gradually and over the long term. It is, as a rule, asking too much of countries with structural shortcomings to develop efficient PFM institutions in a matter of years.

Development cooperation can support PFM reform efforts in various respects; budget support in particular has greatly increased the importance attached to the subject. Specific programmes for the promotion of PFM are also a suitable means of supporting reforms. If, however, the consultancy services and other contributions provided by donors are not themselves subject to transparent and open procedures, their credibility will be questioned. In PFM reforms, it is even more important than in other areas to move away from the fragmented donor projects of the past that relied on parallel structures, and to adopt "competitive approaches" aimed at using and so strengthening the partner countries' systems.

The following points are particularly relevant to development cooperation:

- First, to close the gap between *de jure* and *de facto* PFM reforms, incentives to strengthen reform-oriented forces should be created. Potential activities range from special basket fund approaches to the financing of reform policies, through the promotion of "pioneering institutions" (such as supreme audit institutions and tax authorities), to the promise of budget support.
- Second, greater emphasis should be placed in development cooperation projects themselves on compliance with the principles whose application is required in PFM reform programmes, such as budget transparency and open tendering and procurement processes, which will increase the credibility and effectiveness of those projects.
- Third, PFM reform programmes should be dictated not by donor requirements, but by the specific need for reforms in the country concerned. If efforts are biased towards reducing what donors see as fiduciary risks, the substance of and national backing for a PFM reform programme may suffer.
- Finally, donors should work more systematically on reducing the adverse effects on governance structures of the development assistance they provide. By installing parallel structures for their projects or poaching qualified staff from the public sector, donors contribute to weakening the governance of partner countries. The aim should be, rather, increasingly to convert mechanisms for rendering account to international donors into national mechanisms.

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