

Public Expenditure Working Group
Current Consultative Draft (October30, 2004)

**Supporting Better Country Public Financial Management Systems:
Towards a Strengthened Approach to Supporting PFM Reform**

1. **Effective PFM systems are crucial to countries making progress in reducing poverty.** This connection – between PFM systems and poverty reduction – was given added attention with the introduction several years ago of the HIPC debt relief initiative. Most of the Poverty Reduction Strategies (PRSs) that partner countries have developed recognize explicitly that poverty reduction is not merely a question of spending more, but also using existing resources more effectively. In essence partner countries increasingly recognize that problems in sectors such as health, education, and agricultural can have common origins in weak PFM. The HIPC Assessment and Action Plans (AAPs) were a tool to help countries benchmark the current condition of their PFM systems and to develop plans to strengthen them. Likewise, progress toward achieving the Millennium Development Goals (MDGs) has given additional urgency to improving PFM as an enabling condition for poverty reduction.
2. **A decade of intensive diagnostic work has generated an unparalleled body of information and knowledge on the operation of public financial management (PFM) systems throughout the world.** The diagnostic work that has been undertaken by the IFIs, bilateral donors and countries have formed the basis for public financial management reform programs that exist in countries throughout the world. Efforts to improve public financial management systems are entering a new phase of work. With reform programs in place, the main area of focus for donors and countries alike has shifted from understanding organizational and systemic strengths and weaknesses to implementing reform and improving performance
3. **Diagnostic work has been driven by the desire to support improved PFM practices and by donors' need to collect information to assess fiduciary risks, inform decisions about aid modalities and design appropriate safeguards measures.** The increasing use of budget support ensures that donor's fiduciary concerns will continue to exist.
4. **Despite the diagnostic work and the existence of PFM reform programs, actual progress in improving public financial management performance has been limited.**
5. **This note sets out a proposed approach to supporting improved public financial management performance through aligning donor and IFI assistance to country-led programs of work.** This approach has been developed by the World Bank and the IMF in close consultation with the PEFA program. It identifies a flexible approach to building constructive partnerships among countries, donors, and IFIs focused on delivering results on the ground.
6. **Building upon lessons and good practices from existing work, the Strengthened Approach is designed around three central tenets:**

- (a) Modernizing and increasing the effectiveness of public financial management systems is an activity for governments. Donors can support these efforts but they are not a substitute for government leadership, and should not undermine domestic accountability arrangements.
 - (b) Enhancing the capacity and performance of public financial management systems requires a government-led strategy that is sequenced in accordance with country circumstances, takes account of institutional, managerial, and technical issues, and is supported by donors in a coherent, coordinated, and programmatic manner; and
 - (c) Rigorous and consistent monitoring and evaluation of accomplishments is essential for managing reform, for the creation of effective accountability for reform success and to inform donors' evaluation of the evolution of fiduciary risks.
7. **The remainder of this note provides an overview of the strengthened approach to PFM work.** The rationale for the approach is explained, and the underlying principles are elaborated. Each of the main elements of the approach are described in some detail and a final section of the paper discusses the challenge of operationalizing the approach and the outstanding issues that need to be resolved by donors, IFIs, and their country partners.

RATIONALE FOR THE STRENGTHENED APPROACH

8. **Public financial management (PFM) is an essential part of the development process.**¹ Sound PFM supports aggregate control, prioritization, accountability and efficiency in the management of public resources and delivery of services, which are critical to the achievement of public policy objectives, including achievement of the Millennium Development Goals (MDGs). In addition, sound public financial management systems are fundamental to the appropriate use and effectiveness of donor assistance since aid is increasingly provided through modalities that rely on well-functioning systems for budget development, execution and control.
9. **A significant portion of the analytical underpinning for designing public financial management reform programs has been developed through an extensive set of diagnostic studies and other reports.** Over the course of the last decade, diagnostic instruments and other reports designed to examine the composition and workings of public financial management organizations and systems have been developed and utilized in countries throughout the world. These include the World Bank's Country Financial Accountability Assessments (CFAAs), Country Procurement Assessment Reviews (CPARs), and Public Expenditure Reviews (PERs), the EC's Compliance Tests, and the IMF's Fiscal ROSCs, some or all of which have been performed in a large number of developing countries. The findings of these and other donor/IFI analytical studies have supported the development of national programs to improve planning, spending, and reporting on the use of public funds.
10. **Despite the existence of reform programs, actual progress in improving public financial management performance has been limited.** The instruments used to assess public financial

¹ Public financial management includes all phases of the budget cycle, including the preparation of the budget, internal control and audit, procurement, monitoring and reporting arrangements, and external audit. The broad objectives of public financial management are to achieve overall fiscal discipline, allocation of resources to priority needs, and efficient and effective allocation of public services. See *Harmonizing Donor Practices for Effective Aid Delivery – Good Practice Papers – A DAC Reference Document*, OECD, 2003.

management performance, including the tools listed above and others such as the European Commissions' audits, have documented that many country PFM systems remain weak. Joint World Bank-IMF work in HIPC expenditure tracking further documented the weak state of many country PFM systems.

11. **Approaches to assisting countries' establish effective public financial management systems are evolving.** Countries, donors, and IFIs alike have been working to incorporate innovations in their work in order to get better results from their efforts to support improvements in public spending. Country ownership of reforms has been increasingly emphasized. Examples of active government involvement in diagnostic processes are becoming frequent, with examples also emerging of governments performing assessments (such as in the Indian State of Andhra Pradesh) or managing a yearly review process (such as in Tanzania with its annual public expenditure review). Integrated assessments have also become common as assistance providers seek to reduce the burden being placed on government officials by the volume and frequency of evaluations (See box 1). In some cases such as Turkey, donors have also played a role in facilitating consensus-building across different stakeholders. Recent examples of support for integrated and sequenced action plans, with government taking a strong lead in the process, include Uganda and Cambodia. Moreover, donors and the international community have focused on coordinating their efforts, and designing finance mechanisms that reduce the need to create separate systems to manage donor financing. Efforts are also underway to improve the understanding of the impact of governance and incentives on the performance and reform of the PFM systems.

Box 1: Recent examples of integrated PFM analytic work

In Uganda, a Country Integrated Fiduciary Assessment (CIFA) has been prepared involving various development partners, to provide an integrated and holistic assessment of the PFM system. This consolidates the results and recommendations of the PER, CFAA, CPAR, the tracking poverty reducing spending assessment, and the local government integrated fiduciary assessment. The CIFA led to the preparation of a Government-led integrated action plan.

In Vietnam, the Bank conducted a Public Expenditure Review and Integrated Fiduciary Assessment (PER-IFA) which includes aspects covered in the CFAA, CPAR and PER. This report has paid particular attention to strengthening the links between public spending and poverty reduction and growth goals and strengthening the institutional framework for public expenditure management, transparency and accountability, including at the sub-national and sector levels, to ensure an integrated view of public expenditure management and fiduciary risk. This also included a review of recent public financial accountability reforms. The integrated approach has facilitated policy dialogue. Recommendations of the PER-IFA were incorporated into the Bank's third PRSC to Vietnam.

12. **Approaches to assess fiduciary risks have also been evolving.** Each donor continues, and is likely to continue, to have their own criteria and thresholds when assessing fiduciary risks and taking decision concerning the modality and quantity of its aid. However, recently, increasing attention has been placed on partner countries' interest in strengthening their PFM systems and on the actual progress achieved rather than simply focusing on the level of PFM performance at any given time.
13. **There is a need to capture useful innovations that have arisen within a framework that enhances effective collaboration among the international community and governments.** The modifications that have been made in supporting improvements in public financial management and addressing fiduciary needs have been important but remain partial. Progress has been made in improving country participation but diagnostic instruments are often still deployed to respond to donor and IFI timelines and schedules. The increasing use of budget support has given rise to an entirely new set of ad hoc

fiduciary evaluations and analyses that burden country officials and threaten to create another source of conflicting policy recommendations and advice. As a result, problems now exist not in the absence of reform programs but in their proliferation, with each plan supported by a web of different conditionalities demanded by different donors and IFIs, and related technical support, amidst a tangle of conflicting claims to legitimacy and country ownership. In many countries, it is not unusual to find five or more different action plans in various stages of implementation all designed to enhance financial management. While countries increasingly speak about achieving results, there exists no consistent framework for them or for donors to evaluate the workings of their systems or the progress that has been made to achieving better performance. In sum, there is a need for the creation of a platform that could serve as a common point of dialogue between government and donors, and among donors, that would assist in managing the developmental and fiduciary dimensions of public financial management reform.

The Features of the Strengthened Approach

14. **The strengthened approach reflects the principles that guide all international support for development.** The Monterrey Summit of 2002 proposed a new partnership based on mutual responsibility and accountability between developed and developing countries in support of sound policies, good governance and the rule of law.² The summit emphasized the principle that each country has primary responsibility for its own economic and social development.
15. **The strengthened approach has three components:**
 - A shared agenda - a country led PFM reform strategy and action plan
 - A shared work program - a coordinated IFI-donor integrated, multi-year program of PFM work that supports and is aligned with the government's PFM strategy.
 - A shared information pool – a framework for measuring results that provides consistent information on country PFM performance, including progress over time.
16. **A shared agenda - A country-led PFM reform strategy and action plan.** The starting point for public financial management reform is a country-owned program of reform and a country-owned structure for managing the reform process. For the most part, problems now exist not in the absence of reform programs but in the over-abundance of action plans and while progress has been made in reducing conflicting and overlapping advice, there has been insufficient attention given to prioritizing reform efforts across the financial management system. For example, one country in Africa had three donors supporting three separate, large reform programs simultaneously thereby overloading the country MOF capacity. From a national perspective, the combined programs fail to describe a coherent strategy, as each individual program has been designed by special interlocutors and their sponsors often without reference or knowledge of concurrent reforms being planned in other related areas of the public financial management system. It is important to have a single reform program established by the country for improving public financial management performance.³

² See *Report of the International Conference on Financing for Development*, Monterrey, Mexico (United Nations, A/CONF.198/11), March 18-22, 2002.

³ This may not be captured in a single document, particularly at the outset of reforms when government may wish to commence in a specific area before considering a broader reform program. The critical issue is not comprehensiveness since they may lead to over
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17. **A shared work-program - A coordinated IFI-donor multi-year program of PFM work that supports and is aligned with the government's strategy and budget processes.** Country-led reform programs should form the basis for IFI-donor support. Donor support will include assistance for diagnosis, development of feasible, sequenced action plans, and support for implementation. An effective donor coordination arrangement should streamline the dialogue between government and donors, facilitate donor support to the government budget and PFM reform processes, maximize the sharing of knowledge, and provide a collective framework for managing donor activities. Such an arrangement requires donors to recognize each other's expertise to allow assignment of specific and non-duplicative roles. Collaboration among IFIs-donors would recognize the distinct competences of different donor agencies, and seek to integrate work into a coherent program delivered by a broad-based team. In countries such as Cambodia Vietnam, and Indonesia, great strides are being made in achieving consensus on the roles of different donors
18. **Ideally, a yearly program of support would be defined based upon a dialogue between the government and donors in a government-led forum** – a practice that currently exists in countries such as Mozambique and Tanzania. Support programs would utilize all tools at IFI/donor disposal, including further diagnostic, analytical or advisory work, technical assistance, lending or grants, in-kind support, etc. Though further analytical work might be part of a Government's action plan, the focus would be on capacity building. The emphasis on long-term capacity development would also likely influence the methods of assistance, with greater use of techniques such as partnering, twinning, and other methods designed to ensure organizational change and increased institutional acceptance of a performance-oriented ethic.
19. **Commitment to a coordinated program of PFM work in support of a country strategy is complemented by making use of a country's financial systems to the greatest extent feasible in all forms of aid delivery** Alignment of donor-IFI support with country strategies can also be advanced through the method of providing financial assistance, as well as the financial arrangements surrounding foreign assistance. Rationalizing and coordinating donor practices, such as reducing the need for separate financial and accounting arrangements for donor funds, is important in order to free up scarce human resources needed to implement public financial management programs.
20. **A shared information pool - The final feature of the approach is a monitoring system that provides objective and consistent information on public financial management performance over time.** Until now, there has not been a framework for countries or IFIs-donors to determine the degree to which reforms are yielding improved performance. The absence of reliable information using a consistent set of indicators has created problems for the management of reform and has retarded the ability to identify and learn from reform success. Moreover, the lack of objective information has led to a variety of invasive diagnostic efforts undertaken by donors and IFIs required to satisfy their own fiduciary requirements. To interrupt this costly practice, a system capable of providing such information in a credible manner is therefore needed.
21. **Different arrangements may exist for PFM performance measurement and monitoring depending on country circumstances and accountability requirements of donors.** Some countries, including some middle-income countries may have reasonably robust systems for measuring and monitoring results which could be relied upon by donors. In many other countries, such systems may need to be progressively put in place justifying the need for a credible externally validated assessment of PFM performance. To facilitate this, IFIs-donors have jointly developed an integrated PFM performance

planning but that there is government ownership and commitment to the reforms, for coherence between different elements, and for donor alignment.

monitoring framework, that covers all aspects of the budget cycle including budget formulation and execution, procurement, accounting, auditing and internal and external controls. The framework includes a common set of indicators (attached at annex 1), and an accompanying analytic report, which could provide a common platform for dialogue between government and donors regarding the current performance, recent progress and a single action plan for reform and capacity development. This PFM performance report would describe the country context and environment for reform, elaborate more fully on performance as measured by the indicators, comment on progress with the implementation of the reform program, and judge its likely impact.⁴ It would be informed as far as possible by available analytic work on the country's PFM systems. In appropriate circumstances, drafting the report may involve a self assessment by governments or be a joint exercise by government and donors, which would be externally validated by donors to ensure that a credible and objective assessment results. The report's high-level indicators could be supplemented as needed by detailed indicators on specific aspects of the PFM system. Procurement is one area in which detailed, drill-down indicators have also been developed (see annex 1). The indicators and the report would be modified and adapted as needed based on field testing and implementation experience. To recognize diverse country conditions, some customization may be appropriate (including for sub-national levels, where required), although it is important that the indicators remain constant over time to allow progress to be monitored.

Implementing the Strengthened Approach

22. The components of the proposed approach are expected to be tailored to meet country needs.

While the strengthened approach can be divided into component parts, the objective of the entire approach is to direct interventions by donors, IFIs and countries to the implementation of a country-defined reform strategy. To provide maximal support for achieving improved PFM results, the exact shape that each component of the approach will take will look different in different country circumstances.

23. Many of the features of the strengthened approach have already been utilized in a variety of settings.

As we have stated above, there already exists experience in implementing all of the separate features of the strengthened approach. The challenge of implementation is to learn from these innovations and to modify donor-IFI practices in order to promote constructive partnerships in support of national PFM strategies. Individual case studies that accompany this note explore in greater detail experience implementing an assistance strategy focused on implementing reform. The case of Madagascar illustrates the ability of a country to unify a plethora of reform programs into one coherent whole (as well as the discipline required of IFIs-donors who must accept that some their programs will be set aside in the country-led prioritization process). Tanzania and Uganda offer rich lessons about government leadership and management of the reform process, and there now exist a range of experiences with SWAs and budget support that can be mined for advice and guidance. Finally, the HIPC expenditure tracking assessment and action plan initiative provides valuable experience in utilizing a PFM performance measurement framework.⁵

⁴ Country-specific issues e.g., extractive industries, or aspects of the PFM system requiring special attention could also be covered

⁵ An indicator-based PFM performance monitoring framework has been in use since 2000, when the Boards of the Bank and the Fund requested staff of both institutions to assess how poverty-reducing spending would be tracked in 24 low-income countries benefiting from the Enhanced HIPC Initiative. Staff developed and applied an instrument for assessing public expenditure systems consisting of 15 key indicators of PFM system operation. In addition to the indicators, an Assessment and Action Plan (AAP) includes a brief report providing context to the indicators, an action plan to remedy identified weaknesses, and identification of gaps in *Current Consultative Draft on the Strengthened Approach – Public Expenditure Working Group, October 30, 2004* 6
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24. **How each IFI/donor might implement the approach within their organization will differ.** Different internal organization arrangements and management structures, as well as existing internal mandates, will require different approaches for each IFI/donor in implementing this approach. The World Bank, in collaboration with the IMF and PEFA will create guidance on how to operationalizing this approach, on such aspects as the development and implementation of country PFM improvement programs, measuring results, PFM work programming, and donor coordination. Detailed implementation notes and good practice examples will be prepared and made available to donors and policy makers alike on an on-going basis
25. **Within the World Bank, the approach to PFM analytic work has been changed from the previously mandated “core diagnostic products” (PERs, CFAAs, CPARs) to one that provides flexibility to adapt to country-specific circumstances.** Under this approach, analytic work in a particular country would be programmed taking into account the type and level of Bank engagement, client priorities and circumstances, and the availability of relevant knowledge from partners. The analytic work program would be updated annually. The Bank would carry out analytic work to support the design and implementation of government-owned reform strategies, as needed. This may involve, as appropriate, focused reports/notes on specific topics of interest to the government. The Bank’s analytic work for fiduciary purposes would be based on the size and nature of the Bank’s lending program, and would focus on the institutional environment into which Bank resources are proposed to be transferred as noted above. This recently announced policy change responds to the need for greater flexibility in PFM work, and for analytic work to support country PFM programs (rather than to meet Bank requirements alone).
26. **The World Bank is exploring ideas that would further modify existing procedures for supporting improved public financial management.** To enhance its efforts to connect work on the planning, spending, and accounting for the use of public money and to move towards genuinely integrated analytical products the formation of a country PFM team is proposed. The country PFM team would consist of staff from PREM, Procurement, and Financial Management, and expanded as necessary to include other key actors. The country PFM team would carry out PFM work in the country and support the CD/CMU on these issues. A joint donor-country PFM team that includes donors active or interested in a country’s PFM system would be encouraged and used where appropriate and feasible.
27. **Development partners such as the European Commission and DFID are actively exploring how best to utilize the strengthened approach.** The EC has embarked on an extensive piloting program of the draft PFM performance indicators to determine its potential contribution to their efforts and the extent to which it responds to the EC’s information requirements. DFID has developed guidance for its staff on how to manage fiduciary risk that reflects the organization’s intention of making use of the common framework and pool of information created by the PFM performance indicators.
28. **HIPC-AAP work.** The Bank and Fund are giving consideration as to how the HIPC-AAP exercise could be integrated into this strengthened approach,. One option would be for the PFM performance monitoring framework (indicators and report) to replace the current HIPC-AAP indicators and report. To the extent that formal rounds of reassessments are still required for HIPCs, the PFM performance indicators and report could be applied in the 28 countries currently covered under the HIPC-AAP exercise. Transition arrangements could be developed to ensure continuity and to ensure that the

donor assistance to support reform implementation. A report containing the 2nd round of assessments is planned to be delivered to the Boards in November 2004¹

substantive features of the HIPC-AAP work including Bank-Fund collaborative arrangements are integrated into the strengthened approach.

29. **Next steps in implementing the strengthened approach.** The proposed approach could represent a significant evolution of support to PFM systems that can be characterized as moving from diagnostics to implementation. Fortunately, there is a body of experience to draw upon to ease this shift but the transition process will undoubtedly require revising donor practices and client-donor interactions. We have indicated, within the above discussion of the proposed approach, that guidance will be provided on implementing the approach at a country level. There also exists a need to engage in constructive dialogue with donors and countries on the elaboration of key organizational issues around the major themes of the approach, including:

- Aligning donor support to country priorities – an issue that requires consideration of how to increase the flexibility of donor interventions.
- Tailoring analytical work to meet country needs – an issue that entails reducing and streamlining analytical work to eliminate duplication and standardization.
- Streamlining the content and coordination of donor conditionalities and support – an issue that requires the establishment of effective structures for donor collaboration, as well as the creation of organizational incentives to promote better integration of technical or advisory assistance.
- Ensure a credible assessment of PFM performance over time as an information pool for donors to draw upon for their fiduciary assessments.

ANNEX 1

Consultative draft - PFM performance indicators

A. PFM OUT-TURNS
<ol style="list-style-type: none"> 1. Aggregate fiscal deficit compared to the original approved budget. 2. Composition of budget expenditure out-turn compared to the original approved budget. 3. Aggregate revenue out-turn compared to the original approved budget. 4. Stock of expenditure arrears; accumulation of new arrears over past year.
B. KEY CROSS-CUTTING FEATURES : COMPREHENSIVENESS AND TRANSPARENCY
<ol style="list-style-type: none"> 5. Comprehensiveness of aggregate fiscal risk oversight. 6. Extent to which budget reports include all significant expenditures on central government activities, including those funded by donors. 7. Adequacy of information on fiscal projections, budget and out-turn provided in budget documentation. 8. Administrative, economic, functional and programmatic classification of the budget. 9. Identification of poverty related expenditure in the budget. 10. Publication and public accessibility of key fiscal information, procurement information and audit reports.
C. BUDGET CYCLE
Medium term planning and budget formulation
<ol style="list-style-type: none"> 11. Extent of multi-year perspective in fiscal planning, expenditure policy-making and budgeting, including procurement. 12. Orderliness and participation in the budget formulation process. 13. Coordination of the budgeting of recurrent and investment expenditures. 14. Legislative scrutiny of the annual budget law.
Budget execution including procurement
<ol style="list-style-type: none"> 15. Effectiveness of cash flow and procurement planning, management and monitoring. 16. Procedures in operation for the management and recording of debt and guarantees. 17. Extent to which spending ministries and agencies are able to plan and commit expenditures in accordance with original/revised budgets. 18. Evidence available that budgeted resources reach spending units in a timely and transparent manner. 19. Effectiveness of internal controls, including on procurement. 20. Effectiveness of internal audit, including on procurement. 21. Effectiveness of payroll controls. 22. The existence of a transparent procurement system as an integral part of the overall PFM system which is supported by a clear regulatory framework that provides for competition, value for money and effective controls.
Accounting and reporting
<ol style="list-style-type: none"> 23. Timeliness and regularity of data reconciliation. 24. Timeliness, quality and dissemination of in-year budget execution reports. 25. Timeliness and quality of the audited financial statements submitted to the legislature.
External accountability, audit and scrutiny
<ol style="list-style-type: none"> 26. The scope and nature of external audit. 27. Follow up of audit reports by the executive or audited entity. 28. Legislative scrutiny of external audit reports.

In addition to indicators of country PFM performance, this framework also includes two indicators of donor practices which impact country PFM systems. Through these indicators, donor performance and the extent of the negative impact of donor practices, are also measured.

Indicators of donor practices
Donor 1. Completeness of donor information provided on aid flows, and comparison of actual donor flows with donor forecasts.
Donor 2. Proportion of aid that is managed using national procedures.

This set of high-level indicators could be supplemented as needed by detailed indicators on specific aspects of the PFM system. An example is the set of indicators that have developed for procurement, which is shown in the box below.

Illustration of draft detailed indicators for procurement

These detailed procurement indicators provide a tool to be used to assess the elements of a procurement system against a defined set of standards. The indicators include the following:

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

Central 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 capacity

Procurement operations and market performance

6. Efficiency of procurement operations and practices
7. Functionality of the public procurement market
8. Existence of contract administration and dispute resolution provisions

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