

## ANNEX

# *Supporting Better Country Public Financial Management Systems: Towards a Strengthened Approach to Supporting PFM Reform Joint World Bank/IMF/PEFA Public Expenditure Working Group – Consultative Paper*

### **Introduction**

#### **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 that 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.

A decade of intensive diagnostic and analytic work undertaken by IFIs, donors and countries<sup>1</sup> has generated an unparalleled body of information and knowledge on the operation of public financial management (PFM) systems throughout the world, but an increased focus on implementing reform is now required. The diagnostic work has been undertaken to support development of public financial management reform programmes that now exist in countries throughout the world and also meet the need of donors to collect information to assess fiduciary risks, inform decisions about aid modalities and design appropriate safeguard measures. While some progress has been made, assessments such as the EC's audits and the joint World Bank/IMF work in HIPC expenditure tracking demonstrate that major weaknesses remain in many countries. Efforts to improve public financial management systems are therefore entering a new phase of work. With reform programmes in place, the proposed approach reflects the need to shift country and donor focus from understanding organizational and systemic strengths and weaknesses to implementing reform and improving performance.

• **Innovations in assisting countries' establish effective public financial management systems are taking place in different countries.** These include greater government involvement in diagnostic processes, more integrated and coordinated assessments, support for integrated and sequenced action plans, and recently to better understand the impact of governance and incentives on the performance and reform of the PFM systems. Approaches to assessing fiduciary risks are also evolving. While each donor continues to have their own criteria and thresholds when assessing fiduciary risks and taking decisions concerning the modality and quantity of its aid, increasing attention has recently 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. There is a need to capture the 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 programmes 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 existed 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 was 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.

- **This note sets out a proposed approach to supporting improved public financial management performance through aligning donor and IFI assistance to country-led programmes of work.** This approach has been developed by the World Bank and the IMF together with the Public Expenditure and Financial Accountability (PEFA) programme,<sup>2</sup> and in consultation with the OECD-DAC Joint Venture on Public Financial Management. It identifies a flexible approach to building constructive partnerships among countries, donors, and IFIs focused on delivering results on the ground.

**Building upon lessons and good practices from existing work, the “strengthened approach” is designed around three central tenets:**

1. Modernising 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.
2. 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, co-ordinated, and programmatic manner.
3. 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.

**The strengthened approach**

- **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.<sup>3</sup> The summit emphasised the principle that each country has primary responsibility for its own economic and social development.

**The strengthened approach has three components:**

- A country-led agenda – a country led PFM reform strategy and action plan.
- A co-ordinated programme of support – a co-ordinated IFI-donor integrated, multi-year programme 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.
- **A country-led agenda – A country-led PFM reform strategy and action plan.** The starting point for public financial management reform is a country-owned programme of reform<sup>4</sup> and a country-owned structure for managing the reform process. Country ownership and leadership are critical to successful reform, and the strengthened approach involves development of effective partnership between government and donors to support country ownership. In

developing a country-led reform programme, important considerations for all stakeholders are that the programme is prioritised and feasible, and builds from the country's current circumstances and capacities.

- **A co-ordinated programme of support – A co-ordinated, integrated IFI-donor multiyear programme of PFM work that supports and is aligned with the government's strategy and budget processes.** Country-led reform programme 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 with a clear focus throughout on the goal of capacity development. The programme of support should be integrated across the PFM agenda. An effective donor co-ordination arrangement should streamline the dialogue between government and donors, facilitate donor support to the government budget and PFM reform processes, maximise the sharing of knowledge, and provide a collective framework for managing donor activities. Such an arrangement requires donors to recognise each other's expertise to allow assignment of specific and non-duplicative roles. Collaboration among IFIs-donors would recognise the distinct competences of different donor agencies, and seek to integrate work into a coherent programme 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.

- **Ideally, a yearly programme 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 programmes would utilise 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 organisational change and increased institutional acceptance of a performance-oriented ethic.

- **Commitment to a co-ordinated programme 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. Rationalising 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 programmes.

**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 was therefore needed.

- **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, have reasonably robust systems for measuring and monitoring results which could be relied upon by donors. In many other countries such systems need to be progressively put in place, justifying the need for a credible externally validated assessment of PFM performance. To facilitate this, IFIs and donors have

jointly developed an integrated PFM performance 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 (see Appendix), and an accompanying analytic report, which could provide a common platform for dialogue between government and donors regarding the current performance, recent progress and development of a single action plan for reform and capacity development. This PFM performance report describes the country context and environment for reform, elaborates more fully on performance as measured by the indicators, comments on progress with the implementation of the reform programme, and judges its likely impact.<sup>5</sup> It would be informed as far as possible by available analytic work on the country's PFM systems. The cooperation of government would, of course, always be important, but the nature of the involvement may vary depending on country preferences and circumstances. The government may undertake an initial self assessment, the donors and government may undertake the process together, or the government may just provide information. The assessment would be externally validated by donors to ensure that a credible and objective assessment results. The assessment of the donors should be shared with government and any difference of view clearly recorded. 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 Appendix). 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.

#### **Taking forward the strengthened approach**

**The proposed approach could represent a significant evolution of support to PFM systems that can be characterised as moving from diagnostics to implementation.** The next step is implementation on the ground. This involves tailoring the approach to country circumstances in order to support country-led reform, changes in the nature of country donor interactions, and internal changes within donor organisations to support improved donor practices on the ground. Further dialogue with partner countries and donors is taking place. In implementing the approach, critical challenges for countries and donors include the following: • 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 co-ordination of donor conditionalities and support – an issue that requires the establishment of effective structures for donor collaboration, as well as the creation of organisational incentives to promote better integration of technical or advisory assistance.
- Ensuring a credible assessment of PFM performance over time as an information pool for donors to draw upon for their fiduciary assessments.

## **Notes**

1. Including through the World Bank's Country Financial Accountability Assessments (CFAAs), Country Procurement Assessment Reviews (CPARs), and Public Expenditure Reviews (PERs), the EC's audits, and the IMF's Fiscal ROSCs, some or all of which have been performed in a large number of developing countries.
2. PEFA is a partnership between the World Bank, European Commission, UK Department for International Development, Swiss State Secretariat for Economic Affairs, French Ministry of Foreign Affairs, Norwegian Ministry of Foreign Affairs, the International Monetary Fund, and the Strategic Partnership with Africa.
3. See *Report of the International Conference on Financing for Development*, Monterrey, Mexico (United Nations, A/CONF.198/11), 18-22 March, 2002.
4. 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 programme. The critical issue is not comprehensiveness since they may lead to over planning but that there is government ownership and commitment to the reforms, for coherence between different elements, and for donor alignment
5. Country-specific issues e.g. extractive industries, or aspects of the PFM system requiring special attention, could also be covered.