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**Third Draft**

# PEFA Handbook

# Volume IV: Using PEFA to support Public Financial Management improvement

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## Table of Contents


**PREFACE** ..... **4**

**ACKNOWLEDGMENTS** ..... **5**

**1. BACKGROUND** ..... **6**

PEFA and the PFM reform process ..... 6

Purpose and objectives of this Guidance ..... 7

The seven stages of designing, implementing and monitoring PFM reform ..... 8

Stage 1: Identify PFM strengths and weaknesses ..... 9

Stage 2: Determine the underlying causes of strengths and weaknesses ..... 11

Stage 3: Agree on desired PFM reform outcomes ..... 12

Stage 4: Develop and prioritize PFM reform initiatives ..... 12

Stage 5: Identify potential constraints to reform ..... 15

Stage 6: Implement reforms or reform action plans ..... 17

Stage 7: Monitor and evaluate reform implementation ..... 20

**3. Planning for reform** ..... **24**

Deciding the right approach ..... 24

Further guidance on prioritization and sequencing ..... 25

Managing change ..... 26

Pilot testing the application of Volume IV ..... 28

**A draft Concept Note for pilot testing is presented at Annex 3.** ..... **28**

**REFERENCES** ..... **29**

**Annex 1. Example of Flowchart for Reform Design** ..... **32**

**Annex 2: Concept Note for Pilot Testing PEFA Handbook Volume IV** ..... **33**

# List of Abbreviations and Acronyms

| | |
|---|---|
| DeMPA | Debt Management Performance Assessment |
| FMIS | Financial Management Information System |
| FTE | Fiscal Transparency Evaluations |
| IPSAS | International Public Sector Accounting Standards |
| ICT | Information and Communication Technology |
| L/T | Long Term |
| MAPS | Methodology for Assessing Procurement Systems |
| MoF | Ministry of Finance |
| M&E | Monitoring and Evaluation |
| PDIA | Problem Driven Iterative Approach |
| PEFA | Public Expenditure and Financial Accountability |
| PI | PEFA Indicator |
| PIMA | Public Investment Management Assessment |
| PFM | Public Financial Management |
| S/T | Short Term |
| SAI PMF | State Audit Institution Performance Management Framework |
| SWOT | Strengths, Weaknesses, Opportunities and Threats |
| TADAT | Tax Administration Diagnostic Assessment Tool |
| TSA | Treasury Single Account |

# PREFACE

The Public Expenditure and Financial Accountability (PEFA) Program provides a framework for assessing and reporting on the strengths and weaknesses of public financial management (PFM). A PEFA assessment incorporates a PFM performance report that includes an evidence-based measurement of performance against 31 indicators as well as an analysis of the findings and its impact on desirable budgetary and fiscal outcomes.

The PEFA methodology draws on international PFM standards and good practices and provides a foundation for reform planning, multi-stakeholder dialogue on strategy and priorities, and progress monitoring. The PEFA program also provides support, monitoring, and analysis of PEFA assessments. A key task of the PEFA Secretariat is to ensure the quality of PEFA reports, which is done by in-depth reviews of draft reports and anchoring of the PEFA Check requirements. Please visit www.PEFA.org for more information about the Program and the PEFA Check requirements.

The purpose of the PEFA handbook is to provide users, including government officials (at both central and subnational government), assessors, development partners and other interested stakeholders, with guidance on planning, implementing, reporting, and using the *PEFA Framework for assessing public financial management* 2016 (PEFA 2016).

The handbook is presented in four separate volumes:

- *Volume I: The PEFA assessment process: planning, managing and using PEFA,* provides guidance to PEFA users and other stakeholders on the key phases and steps in the PEFA assessment process.
- *Volume II: PEFA assessment fieldguide,* is a detailed technical guidance on scoring the 31 performance indicators and 94 dimensions of PEFA 2016, including data requirements and sources, calculation and definitions. The field guide also includes a glossary of terms.
- *Volume III: Preparing the PEFA report,* contains advice on writing the report and a template and instructions for each section and annex of a standard PEFA report.
- *Volume IV: Using PEFA to support PFM improvement*, provides guidance on how to use PEFA assessments as part of a stakeholder dialogue to develop and sequence PFM reform initiatives.

Each volume of the handbook is intended to be a dynamic document that will be updated in response to common issues, good practices, suggestions, and frequently-asked questions from PEFA users. Periodic updates to the handbook volumes are announced and published on the PEFA website (www.pefa.org).

# ACKNOWLEDGMENTS

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# 1. BACKGROUND

A successful PEFA assessment requires the commitment of all major stakeholders involved in PFM in a country. Nevertheless, it is the government that should be the driving force for the assessment and “own” both the process and results of the assessment, as well as lead the efforts to build on the strengths, and address any weaknesses, identified in the PEFA report.

In this context, governments have been increasingly seeking the advice of the PEFA Secretariat for information on how PEFA reports can be used more effectively to improve PFM performance. This Volume of the PEFA Handbook has been developed in response to these requests. However, while the strategic and operational importance of PFM reform is generally recognized, this guidance makes clear that that there is no ‘one size fits all’ solution to supporting and implementing PFM reform and it is important to use PEFA assessment findings in the country context.

## PEFA and the PFM reform process

PEFA reports, when done well, provide a technically sound basis for developing and undertaking PFM reforms. The PEFA framework provides a 360-degree overview of PFM, with evidence-based assessments and a scoring methodology and peer review process that counter risks of potential optimism bias in the assessment process. The framework facilitates comparison over time and between countries and regions and is internationally agreed upon and supported through strong collaboration between key development partners.

The focus of this volume of the PEFA Handbook is on the use of PEFA reports for supporting PFM reform dialogue, planning, design and implementation.

However, it is important to note PEFA assessments’ strengths and limitations when using PEFA reports as the basis for PFM reform dialogue and design. PEFA assessments do not capture all aspects of PFM at a deep level of detail and, and as is discussed later in this guidance, additional analyses may sometimes be needed to better understand the underlying technical and non-technical causes of performance levels.
If not used correctly or without appropriate, PEFA assessments can sometimes lead to standardized reform approaches that do not take account of the local context. While the PEFA scoring methodology embeds good international practices, applied incorrectly, the A to D rating can lead to focusing on improving all low scores without appropriate attention to capacity and other constraints, political priorities, sequencing and importance, and other local circumstances. It is therefore important that PEFA Assessments findings are interpreted and used in a way that reflect the circumstances and priorities of the country in which it is applied.

PFM reform will not succeed without a solid technical foundation. However, by the same token, technically sound reform initiatives will not succeed without adhering to the following principles:

- Understanding the important role of non-technical factors (e.g. political economy, technology and capacity) in the design of PFM reform.
- The need to involve broader stakeholders’ groups before and during reform design, implementation and evaluation.
- Ongoing monitoring, learning, feedback and adjustment during reform implementation is key to countering unforeseen events and constraints and/or leveraging opportunities.

## Purpose and objectives of this Guidance

Good PFM performance is determined by the ability of the PFM systems to support the effective and efficient achievement of policy objectives while maintaining macro-fiscal control as measured by the three main fiscal and budgetary outcomes: aggregate fiscal discipline, strategic allocation of resources and efficient service delivery[1].

The purpose of volume IV is to provide a practical guide to support the design of PFM reform initiatives and action plans informed by a PEFA assessment.

The objective of Volume IV is to support the development and implementation of PFM reform initiatives that:

- have the commitment and ownership of government;
- are based on clearly stated desired PFM outcomes;
- consider and address potential constraints;
- reflect government priorities and capacities; and
- are sequenced in accordance with the desired policy outcomes, government priorities and potential constraints (including non-technical constraints to reform).

Volume IV is not intended to be prescriptive in setting recommendations on reform priorities or sequencing. Rather, it is intended to provide a guide for countries on the issues that need to be considered in developing effective reform initiatives, strategies or action plans, designed to address each country's unique situation. In this context, it will also be important to take stock of existing relevant analytical work, the country's development strategies and other relevant documents. This is essential for fully understanding the country context including the technical and non-technical constraints and opportunities for reform, including capacity constraints, as well as the need to leverage the institutional links between finance ministries and other stakeholders involved in PFM reform.

The guidance therefore calls for building on existing PFM reform/improvement strategies where these exist. The guidance also suggests building on those reform elements that have succeeded (and the lessons that can be drawn from successful implementation) and addressing those areas that have not been so successful (and similarly draw lessons on why these reforms have not been successful).

While the PEFA Secretariat is available to provide further guidance on how to use PEFA assessments to support PFM improvement, including training workshops to facilitate PFM reform dialogue and action planning, it does not provide direct technical support for implementing PFM action plans or specific reform initiatives.

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[1] Aggregate fiscal discipline requires effective control of the total budget and management of fiscal risks. Strategic allocation of resources involves planning and executing the budget in line with government priorities aimed at achieving policy objectives. Efficient service delivery requires using budgeted revenues to achieve the best levels of public services within available resources.

# 2. PEFA AND PFM REFORM: A PRACTICAL GUIDE

The initial dialogue after a PEFA assessment report is completed should focus on the PFM strengths and weaknesses and other problems identified by the report and address whether there is a need for further analysis of the underlying causes of such weaknesses. Countries should also consider other analyses and assessments of underlying issues, such as those undertaken internally in government, by think tanks, fiscal councils, supreme audit institutions, NGOs, and others. A review of existing assessments and audits and other report is recommended. Reports may include internal and external audit reports, procurement audits, service delivery assessments, surveys and sector reviews among others.

Findings and recommendations of other broad PFM diagnostic tools (for example, the International Monetary Fund's Fiscal Transparency Evaluation) or technical assistance reports may also be used. This could include the application of other PFM diagnostic tools that focus on individual elements of PFM, such as Tax Administration Diagnostic Assessment Tool (TADAT), Debt Management Performance Assessment (DeMPA), Methodology for Assessing Procurement Systems (MAPS).

Some of these diagnostic tools may have been applied prior to the PEFA assessment, and relevant data and analysis reflected as evidence in the PEFA report. At other times, , governments may see a need to apply one or more of these diagnostic tools after a PEFA assessment, although countries need to be mindful of the resources and time required for such analyses.

Specific reform initiatives may be developed as part of a comprehensive and integrated strategy and reform program or more loosely based on individual prioritized problem-driven initiatives. Whether to have a formalized and structured reform action plan or strategy, or a more ad hoc approach, will depend on the country's technical capacity and institutional environment, as well as the extent to which problems, solutions and commitments are adequately understood and agreed on at the outset.

## The seven stages of designing, implementing and monitoring PFM reform

This guide aims to assist practitioners to develop and implement PFM reform initiatives following completion of a PEFA assessment. It sets out seven key stages of designing, implementing and monitoring PFM reform. These stages have been based on the practical experiences of governments and advisers that have successfully implemented reform initiatives.

While it is expected that each of the stages will involve extensive dialogue among various stakeholders, the guide has been developed on the premise that it is the government that is responsible and accountable for prioritizing and implementing PFM reform.

The key stages are summarized in table 2.1 and further elaborated below, including with examples.
A flowchart, based on the seven stages, is presented in Annex 1 to guide PFM reform practitioners through each of the key stages with a series of key questions. Suggested actions are presented based on the responses to key questions.

The seven stages, and corresponding flow chart, is provided as a heuristic tool only. It is not intended to be prescriptive, and, application of the guidance provided in this volume may not always be linear. Several iterations may be required for any or each of the questions set out in the flowchart.

**Table 2.1: Overview of stages of the PFM Reform dialogue**

| Stage 1: IDENTIFY PFM STRENGTHS AND WEAKNESSES | Stage 2: DETERMINE UNDERLYING CAUSES OF STRENGTHS AND WEAKNESSES | Stage 3: AGREE ON DESIRED PFM REFORM OUTCOMES | Stage 4: DEVELOP AND PRIORITZE PFM REFORM OPTIONS | Stage 5: IDENTIFY POTENTIAL CONSTRAINTS TO REFORM | Stage 6: IMPLEMENT REFORMS/ REFORM ACTION PLANS | Stage 7 MONITORING, EVALUATION AND ADJUSTMENT |
|---|---|---|---|---|---|---|
| Present a list of strengths and weaknesses identified in the PEFA report | Agree if analysis to be undertaken to identify the technical and non-technical causes or contributing factors to the strengths and weaknesses | Agree on the desired PFM outcomes to come from addressing the problems and weaknesses | Develop a set of reform initiatives that address the weaknesses identified and support the achievement of the desired PFM outcomes. Agree the order of priority of the reforms. Review priority based on constraints identified in stage 5. | Identify constraints to successfully implementing reform and possible actions to mitigate those constraints | Implement specific actions, identify responsibilities, timelines, and capacity development needs. This could be as individual initiatives or part of a reform strategy or action plan. | Monitor the implementation of reforms and individual actions. Review and modify reform initiatives or plans. |

The seven stages, key questions and the processes highlighted in the flow chart, are elaborated below. An example is included in Annex 1.

## Stage 1: Identify PFM strengths and weaknesses

### 1) What is the problem?

The **driver for PFM reform may not always be a PEFA assessment**. Sometimes it can be the result of the government's desire to improve overall economic performance, service delivery or another aspect of public administration. The first question – 'what is the problem?' – provides an opportunity to **identify broader policy issues** that may have a PFM-related element. It also recognizes that the problem may need to be addressed through non-PFM actions and solutions

If the process starts with problem identification, the next question is what can the PEFA report tell us about the systemic PFM weaknesses that may be contributing to the problem that have been identified in the assessment.

In this context, it will also be important to **take stock of relevant analytical work**, the country's development strategies and other relevant documents, in order to fully understand the country's context, reform priorities and technical and non-technical constraints or opportunities for reform

> An example of this approach would be if a country identified poor education outcomes specifically low levels of academic achievement – as the broader policy problem. The causes of the poor performance may be due to non-PFM related matters—such as poor teacher training, outdated curriculum, lack of facilities, and so on—. The PEFA report could, for example, identify a range of issues that could potentially undermine the ability to achieve the government's desired education outcomes, including unpredictable budget allocations, lack of commitment control, inadequate or non-existent cash flow forecasting, planned resources not reaching end users or a lack of performance information.

## 2) What are the findings of the PEFA assessment?

For some countries, it will not be the problem identification envisaged in question 1 that will be the main driver of reform, but the PEFA report itself. The driver for reform may sometimes be a combination of problem-driven reform and the results of the PEFA assessment as well as other diagnostic assessments, evaluations or government decisions.

It might be useful at this stage to **create a matrix PFM reform with a list of strengths and weaknesses** identified by the PEFA report (as illustrated in table 2.3 below) that can provide the basis for further discussion as part of the PFM reform dialogue. The example matrix will be expanded to reflect each of the stages and will include example data for illustrative purposes (see below).

It is important to caution that it may not be realistic or desirable for all countries to aspire to an A score for all performance indicators or, that a 'C' or even 'D' score, will always indicate a need for a specific reform (as for example with the Norway 2009 self-assessment)[2]). It is sometime necessary to look beyond simply the low scores to the country context and relative importance of specific importance and impact of the performance of specific indicators on overall PFM performance.

The weaknesses identified should be presented from the highest to the lowest priority with key stakeholders (government agencies, decision-makers, development partners and civil society ) participating in this initial prioritization process. Sometimes, a low score may not be a priority for reform, sometimes an A score may hide significant problems (for example, an A in PI-1 Aggregate Budget Outturn may be the result of cash rationing rather than good budget planning).

This stage reflects only an initial prioritization. Sequencing of reform initiatives will need to consider other factors, including resources, capacities, institutional constraints, political commitment and others which are discussed further below. These factors will determine whether it is feasible to implement a particular reform and its priority relative to other possible reforms.

**Table 2.3: Example PFM reform matrix: Strengths and weaknesses identified by PEFA assessment**

| Performance indicator/ dimension | PEFA Score | Underlying strengths and weaknesses |
|---|---|---|
| PI-1 | D | Aggregate expenditure outturns exceed original budget by more than 20% in last three years |
| PI-2.1 | D | Significant variation in budget composition by function undermining the predictability and availability of budget allocations to key service delivery agencies. |

[2] Norway's self-assessment in 2009 gave the government several C scores as well as a couple of D scores, with particular weaknesses identified in internal audit and procurement. The Norwegian response was to acknowledge that procurement systems needed improving, but that internal audit reforms were not necessary given the strong internal controls that were already in place.

## Stage 2: Determine the underlying causes of strengths and weaknesses

### 3) What are the causes of strong and poor PFM performance identified by the PEFA assessment?

Once the PFM strengths and weaknesses have been identified and weaknesses initially prioritized, **further analysis may be required to establish or better understand the underlying technical and non-technical causes** or contributing factors to both the strengths and weaknesses. While a PEFA report provides extensive evidence for scoring an indicator or dimension it does not always identify all the technical and non-technical causes of good or poor performance. PFM reforms seldom start from a 'clean slate' so analysis of what has worked what has not worked and the lessons learned is particularly important in understanding the underlying causes of PFM performance as well as guiding reform initiatives, and the identification of constraints, in later stages.

**Further analysis may take different forms.** Some problems might require more formal technical analysis while others may be addressed by more informal quick enquiry. In some cases, governments may choose to apply other PFM diagnostic tools in addition to a PEFA including tools that target specific aspects of PFM (such as TADAT for monitoring tax administration or Public Investment Management Assessment for monitoring public investment). A PEFA Secretariat's study Stocktake of PFM Diagnostic Tools, identifies a total of 46 diagnostic tools for PFM systems in use as at December 2016 . In other cases, governments may apply other tools including SWOT analysis or PDIA approaches (such as the Harvard PDIA toolkit ). The companion document, Guide to PFM Diagnostic Tools highlights the coverage of each tool but does not provide recommendations on which tools to use.

It is important to identify such **factors as they may also act as constraints or enablers** to developing and implementing reform (this is discussed further in stage 5). Such analysis may identify reform issues that are technically feasible but politically unacceptable. Sequencing and prioritization should take place following a more comprehensive 'deep-dive' into the non-technical factors.

Building on the example matrix of weaknesses and strengths identified in stage 1, we can now add the underlying causes of strong and poor performance.

**Table 2.4: Example PFM reform matrix: Underlying causes of strengths and weaknesses**

| Performance indicator/ dimension | PEFA Score | Main strengths and weaknesses | Underlying causes |
|---|---|---|---|
| PI-1 | D | Aggregate expenditure outturns exceed original budget by more than 20% in last three years | • Overoptimistic economic and fiscal projections;<br>• Unavailability of economic and fiscal forecasting models;<br>• Lack of capacity in economic and fiscal forecasting<br>• Political involvement in setting fiscal projections |
| PI-2.1 | D | Significant variation in budget composition by function undermining the predictability and availability of budget allocations to key service delivery agencies. | |

## Stage 3: Agree on desired PFM reform outcomes

### 4) What are the government's desired outcomes of PFM reform?

Once the underlying causes of the weaknesses are understood, the government should decide the outcomes it wishes to achieve through PFM reforms.

Identifying the desired reform outcomes **helps to guide how the government prioritizes and sequences its reform efforts**. By doing this, the government is better able to focus on and prioritize those reform initiatives that will help to achieve those outcomes.

In identifying the desired PFM reform outcomes, it may be useful to **draw on any policy objectives contained in national development strategies or plans and/or relevant sector strategies and objectives.** This enables practical alignment of the reforms to national objectives. Similarly, a comparison of the problem analysis and country development goals and objectives will also help to identify or clarify the desired PFM outcomes. This will strengthen the case for reform and its relevance to the government concerned.

Building on the example matrix, the government's priority outcome may, at this stage, be to strengthen fiscal discipline. The government may consider this as the key for improving budget reliability and ensuring resources are allocated to spending agencies in a predictable manner that supports service delivery and the achievement of the government's goals.

**Table 2.5: Example PFM reform matrix: Desired PFM outcomes**

| Performance indicator/ dimension | PEFA Score | Main weaknesses identified | Underlying causes | Desired outcomes |
|---|---|---|---|---|
| PI-1 | D | Aggregate expenditure outturns exceed original budget by more than 20% in last three years | • Overoptimistic economic and fiscal projections;<br>• Unavailability of economic and fiscal forecasting models;<br>• Lack of capacity in economic and fiscal forecasting<br>• Political involvement in setting fiscal projections | • Strengthen fiscal discipline through: greater adherence to fiscal targets.<br>• Improved predictability of budget allocations to service delivery ministries. |
| PI-2.2 | D | Significant variation in budget composition by function undermining the predictability and availability of budget allocations to key service delivery agencies. | | |

## Stage 4: Develop and prioritize PFM reform initiatives

### 5) Which initiatives can bring about the desired outcomes?

The next stage is to design specific reform initiatives aimed at achieving the desired outcomes.

Each reform initiative or action should include a brief **description of the intended result of that action**; the **impact** on (or progress towards) the desired PFM reform outcome; an initial **timeframe** for completing the action (and any result milestone over the short, medium and longer term depending on the nature of the reform); and the allocation of **responsibility within the government** for implementation.

Continuing with our example matrix, a first priority may be to develop reforms aimed at improving the reliability of budget estimates by reducing the gap between budget allocations and actual expenditures. This may require improvements in macro-economic modelling and fiscal forecasting, strengthened rules on limiting post-budget spending decisions or implementing commitment control to reduce arrears. In turn, strengthening macro-fiscal forecasting may require improvements to national accounts, development of new economic models or the elimination of political interference in forecasting.

It is important to note that alternative desired outcomes may lead to different reform priorities and initiatives. For example:

The government may identify improving service delivery outcomes as its main priority. Such a priority may also require improvements in the reliability of budget allocations and other initiatives that impact on fiscal discipline, but it may also require improvements to capturing performance information or better understanding of the availability of resources to service delivery units.

## 6) What are the most important reforms and how do we sequence them?

When a PEFA report highlights a significant and wide range of PFM weaknesses, the challenges may seem overwhelming. Worse, countries and development partners may try to adopt all-encompassing, comprehensive reform plans that are beyond the capacity of countries to implement and beyond the resources of development partners.

Despite some attempts to agree on sequencing in planning PFM reforms, a consensus among PFM experts has not emerged. Nevertheless, as a starting point, consideration should be given to the feasibility and desirability of adopting a "basics first approach". This approach stresses the important principle of "getting the basics right" as a priority when undertaking reform. The aim with this approach is to avoid over-ambitious attempts to establish PFM international best practices in countries that lack the capacity to operate even basic processes. For example, ensuring the legal environment exists, and sufficient capacity is built, before embarking on capital intensive automated systems. Lessons from experience and academic research lead to the conclusion that appropriate **reform program design and optimum sequencing**, including what constitutes 'basics only' as well as 'capacity development needs and priorities' **will be country-specific based on the unique political, institutional and capacity characteristics of that country**.

**Cost considerations** also need to be considered in setting reform priorities. Reform plans need to **take account of available financial resources**. For example:

The government may consider the implementation of a new FMIS a high priority, but the cost of development, implementation and capacity development may be prohibitive for the time being. Some of the gains from a new FMIS could be achieved through the adoption of less expensive improvements to processes, regulations and classification. Similarly, particularly where the level of government commitment and ownership may be less than desirable, government officials may wish to consider some of the less complex reforms that may provide some 'quick wins' on PFM reform for the government and help build momentum for further reform.

It is also important to be aware that **some priorities are both causally and sequentially linked** (for example, improvement in revenue arrears (PI-19) may require strengthening in revenue outturns, which may require better information on revenue collections and more timely reconciliation (PI-20)).

In our example matrix , the country identified three reform priorities based on its desired outcome of improving fiscal discipline:

| Reform priorities | Why? |
|---|---|
| 1. Strengthening macro-fiscal forecasting; | Strengthening macro-fiscal forecasting is identified as the most important reform due to the consistent, and significant, variations in budget outturns and composition. This has led to continuous reallocations across expenditure items, cash rationing and an inability for ministries to plan their expenditures with any certainty. |
| 2. Implementing cash flow forecasting; | The second priority follows from the first insofar as ministries need to plan for their cash allocations, based on realistic budgets, in accordance with their program needs. |
| 3. Updating budget processes and procedures. | The third priority, updating budget processes and procedures, is recognized as an essential reform initiative to support decision-making in prioritizing budget allocations and strengthening adherence to both aggregate and ministerial budget allocations. |

<table>
<tr><th colspan="6">Table 2.6: Example PFM reform matrix: Proposed reform and priority</th></tr>
<tr><th>Performance indicator/ dimension</th><th>PEFA Score</th><th>Main weaknesses identified</th><th>Underlying causes</th><th>Desired outcomes</th><th>Proposed reform activity and priority</th></tr>
<tr><td rowspan="2">PI-1</td><td rowspan="2">D</td><td rowspan="2">Aggregate expenditure outturns exceed original budget by more than 20% in last three years</td><td rowspan="3">• Overoptimistic economic and fiscal projections;<br>• Unavailability of economic and fiscal forecasting models;<br>• Lack of capacity in economic and fiscal forecasting<br>• Political involvement in setting fiscal projections</td><td rowspan="3">• Strengthen fiscal discipline through: greater adherence to fiscal targets.<br>• Improved predictability of budget allocations to service delivery ministries.</td><td>Strengthening macro-fiscal forecasting (high)</td></tr>
<tr><td>Implementing cash flow forecasting (medium)</td></tr>
<tr><td>PI-2.2</td><td>D</td><td>Significant variation in budget composition by function undermining the predictability and availability of budget allocations to key service delivery agencies.</td><td>Updating budget processes and procedures (high)</td></tr>
</table>

**Box 2.1: Using PEFA for prioritization and sequencing of PFM reform: An example – budget credibility and fiscal discipline**

Budget credibility and fiscal discipline *“are often the first and foremost concern in many developing countries, with any efforts at addressing the other PFM objectives – strategic allocation of resources and efficient service delivery.”* In the following example, we take the case of a country that exhibits low budget credibility and poor fiscal discipline. The government has decided that addressing poor performance in these areas is the first priority of the country’s PFM reform strategy.

The PEFA report confirms the government’s concerns. The PEFA indicators most relevant for measuring budget credibility in a country might be: PI-1 (Aggregate expenditure outturn), PI-2 (Expenditure composition outturn), PI-16 (Medium term perspective in expenditure budgeting) and PI-17 (Budget preparation process). For fiscal discipline, the relevant performance indicators are PI-14 Macroeconomic and fiscal forecasting) and PI-15 (Fiscal strategy).

The next step is to define the causes that lead to poor scores on these indicators, and to make an analysis of each of these factors, drawing on PEFA assessments and other diagnostic reports. These causes could be legal, administrative, technical or institutional (for example, political economy). In some cases, there might be insufficient information to draw any firm conclusions about the causes of inferior performance. Further analysis by the relevant government agencies may be needed or additional diagnostic work might be commissioned.

Common causes of poor budget credibility include unreliable or unrealistic macroeconomic forecasts that underpin fiscal forecasts. This may be the result of institutional factors (for example, underlying national accounts data are untimely and inaccurate); technical weaknesses (for example, lack of internal capacity and expertise to prepare macroeconomic forecasts); or political economy factors (such as government manipulation of the projections to provide a more positive bias).

The question is then whether these data can be improved and whether these institutional, political and technical impediments can be overturned. For example, can the national statistics office improve the timeliness of the production of its national accounts data; can the ministry of finance strengthen the skills of the macroeconomic unit and improve the robustness of its macroeconomic modeling and fiscal forecast; can political interference in the economic forecasting be addressed through greater independence and greater transparency of macroeconomic and fiscal forecasting.

The next step is to assess how possible it would be in the short run and in the longer run to make improvements in the regulations identified. Political, technical and institutional causes should be addressed in turn. To each of these factors the government (with the support of its development partners) would assign a low, medium or high probability of success. This may result in the identification of some dead-ends from which no prospect of success can be gleaned.

Dialogue among stakeholders at the political level is therefore critical for the approach to work well. Political input is required at two levels: (i) how to prioritize the various reform measures that would emerge from the analysis, and (ii) how to analyze the severity of the institutional constraints that might have an impact on the implementation of each potential reform option.

## Stage 5: Identify potential constraints to reform

### 7) What are the constraints to reform?

Based on the prioritized list of reform initiatives identified in stage 4, the government, in consultation with other stakeholders (including technical experts and decision-makers at both the executive and political level), should next **identify potential impediments** to successfully implementing reform **and possible measures to mitigate the impact of those impediments**. A checklist of risks arising from the various sources can be formulated to guide reform design. In some cases, the constraints may be so great that they cannot be resolved, in which it may be advisable to recommend that the government should not engage in a specific reform at that point in time.

It is generally recognized that non-technical factors play an important role in PFM performance. Such factors can significantly vary between countries and over time. Addressing these factors as part of PFM reform requires political and bureaucratic commitment, learning new skills and acceptance of organizational change. As with sequencing and prioritization the approach to **identifying technical and non-technical constraints will vary depending on context.**

Table 2.7 below describes some common constraints to implementing reforms (including non-technical factors) and suggests ways to mitigate those constraints.

| Table 2.7: Potential constraints to PFM reform | | | | |
|---|---|---|---|---|
| **Constraint** | **Manifestation** | **Potential impact** | **Risk (H, M, L)** | **Mitigation strategy** |
| **Political environment** | Unwillingness of senior politicians and/or senior bureaucrats to support reform implementation | Critical. Inability to effectively implement and/or embed reform.<br>Lack of cooperation or resistance among key stakeholders.<br>Lack of adherence to new processes and procedures. | High. Few reforms will be successful without the commitment of senior levels of government. | Seeking endorsement of political leadership.<br>Raising awareness of the benefits of reform.<br>If endorsement is not achieved it may be necessary to defer reform and pursue other priorities that are endorsed and supported by government. |
| **Government and development partner engagement** | Reform design is not internally driven. | Reform design is undertaken by development partners and reflects their priorities rather than the governments. | Variable: The risk depends on the extent of commitment and engagement of the government. The less engagement, the higher the risk that development partners will engage in technical assistance that does not reflect the government's priorities. | Reform initiatives should be tailored to the specific administrative and political circumstances of a country. |
| **Technical capacity** | Staff lack specific competencies to develop and/or support implementation. | Significant. Both short and longer-term impact on the ability to implement the reform. | High. An understanding of the reform, and its application is essential. | Capacity development |
| **Institutional environment** | Institutions and/or organizational structures are not sufficient or appropriate for supporting reform implementation | Significant. Inadequate supervision, and workflow management and monitoring | Moderate. It may be possible to establish alternative management and workflow arrangements. | Organizational restructuring to support reform initiative. |
| **ICT Systems capacity** | The administration lacks systems hardware and software to support reform initiative. | Moderate. Some reforms require more advance systems and software, e.g. FMIS. | Moderate. Manual processes and procedures can be used pending the acquisitions of software and systems. | Development partner support and technical assistance. |

## 8) How are the constraints addressed?

This question relates to **how the constraints can be resolved or mitigated**; that is, what needs to be done to enable the reform. In the flowchart example in Annex 1, it is determined that there are no political constraints, but there are both institutional and technical constraints.

In our example matrix technical constraints are considered to be resolvable through the creation of a dedicated macro-economic and fiscal unit and technical skills and capacity development in economic modeling and fiscal forecasting for the staff of the macro-economic and fiscal unit.

For many countries it is capacity constraints – staff resources and technical skills - that present that largest impediment to reform. The need to address this constraint need to be closely considered in any reform design.

Partnerships with development partners – who may be able to provide technical assistance and other support – can be extremely effective.

If it is not possible to resolve or mitigate a constraint—for example where there is no political will or engagement for reform—then governments and stakeholders should not proceed with implementation until circumstances are more favorable. In cases where constraints can be mitigated in the short or medium-term – for example capacity development - governments should consider acting to do so.  However, the cost, priority and sequencing of these actions should also be considered as part of any PFM reform program.  Alternatively, the government may wish to **identify alternative technical solutions**; however, these will also be subjected to analysis of potential implementation constraints.

Alternatively, reform actions may be postponed while acceptance and support for the reforms is being built through advocacy and other means.

A further column on constraints to reform is now added to  our example PFM reform matrix shown in table 2.8. The completed matrix can now help guide users in establishing a prioritized list of reforms that is achievable within the known technical and non-technical constraints.

**Table 2.8: PFM reform matrix: Constraint to reform**

| Performance indicator/ dimension | PEFA Score | Main weaknesses identified | Underlying causes | Desired PFM outcomes | Proposed reform and Priority | Constraints to proposed reform | Addressing constraints |
|---|---|---|---|---|---|---|---|
| PI-1 | D | Aggregate expenditure outturns exceed original budget by more than 20% in last three years | Overoptimistic economic and fiscal projection;<br><br>Unavailability of economic and fiscal forecasting models;<br><br>Lack of capacity in economic and fiscal forecasting<br><br>Political involvement in setting fiscal projections | Strengthen fiscal discipline through:<br>• greater adherence to fiscal targets.<br>• Improved predictability of budget allocations to service delivery ministries. | 1. Strengthening macro-fiscal forecasting (high)<br><br>2. Implementing cash flow forecasting (medium)<br><br>3. Updating budget processes and procedures (high) | Lack of capacity in economic modeling and analysis.<br><br>Political interference in setting macro-fiscal projections.<br><br>Unwillingness of line ministries to adhere to budget processes and procedures | Recruitment and training of macro-economists.<br><br>Strengthening the legal framework underpinning budget planning and preparation. |
| PI-2.2 | D | Significant variation in budget composition by function undermining the predictability and availability of budget allocations to key service delivery agencies. | | | | | |

## Stage 6: Implement reforms or reform action plans

### 9) What are the actions, deliverables, responsibilities and timelines?

The next stage focuses on confirming the reform initiatives and developing a reform action plan or strategy for implementation.

Table 2.9 provides a template for developing a PFM reform plan that can be adapted for iterative approaches for reform or more sophisticated and comprehensive reform strategies. The template does not intend to be prescriptive nor exhaustive. **The template is simple as guide to the key elements to be addressed** in designing a reform plan, whether this involves individual reform initiatives or a more detailed comprehensive strategy. .

**Table 2.9: Key elements of a PFM reform action plan**

| DESIRED OUTCOME | PFM REFORM | KEY TASKS/ ACTIONS | RESPONSIBILITY | TIMEFRAME | KEY MILESTONES/ OUTPUTS | CAPACITY DEVELOPMENT NEEDS | COST AND FUNDING SOURCE |
|---|---|---|---|---|---|---|---|
| State the govt's intended outcomes expected from PFM reform | Specify the reform priorities or initiatives | Set out the individual tasks required to implement the reform | Identify institutional and individual responsibility for completion of each task | Set out the deadline for each task | Identify milestones | Set out required capacity development needs | Estimate cost and funding source |

Table 2.10 below includes a simplified example of the above template applying the example we used from stage 1 to stage 5 to address specific reform priorities centered on the need to improve fiscal discipline.

The example aims to demonstrate the program logic for developing and implementing reform priorities resulting from the PFM reform dialogue, highlighting the specific outcome that the reform is intended to achieve (or contribute to) and the specific tasks required to achieve that outcome, along with responsibility, timeframe, any specific milestones and capacity development needs. In designing reforms, the cost implications should be considered. Consideration should be given to both recurrent cost implications and from short term reform action costs. The latter is sometimes funded by development partners. The former is almost always expected to be funded by governments themselves. Cost estimates should be done before funding sources and amounts can be considered.

**Table 2.10: Illustration of key elements of a PFM reform action plan using our example**

| DESIRED OUTCOME | PFM REFORM | KEY TASKS/ ACTIONS | RESPONSIBILITY | TIMEFRAME | KEY MILESTONES/ OUTPUTS | CAPACITY DEVELOPMENT NEEDS | COST AND FUNDING SOURCE |
|---|---|---|---|---|---|---|---|
| Strengthen fiscal discipline through greater adherence to fiscal targets | Strengthening macro-fiscal forecasting | Establish a Macroeconomic and Fiscal Forecasting Unit | Director, HR, MoF | Dec 2019 | Staff recruited for macro-economic and fiscal unit July 2019 | Technical support and training staff of macro-economic and fiscal unit | $$ |
| Improved predictability of budget allocations to service delivery ministries | | Design a medium term fiscal framework (MTFF) | Budget Director, Ministry of Finance | Aug 2020 | Develop macro-economic model used for budget preparation by July 2020 | Technical support and training staff of macro-economic and fiscal unit | $$ |
| | | | | | Medium-term macro-fiscal forecasts based on new model prepared by Aug 2020 | | |
| | | | | | Prepare and publish MTFF by Aug 2020 | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Implementing cash flow forecasting | Develop and distribute circular advising Ministries to prepare monthly cash flow forecasts | Accountant-General, MoF | Dec 2019 | Budget call circular July 1, 2019 | Not required | No additional cost |
| | | Require ministries to update cash flow forecasts each month | Accountant-General, MoF | Jan 2020 | From 2020 budget year | Not required | No additional cost |
| | Update budget processes and procedures | Revise budget calendar | Budget Director, MoF | Mar 2019 | Revised budget calendar approved by Cabinet | Technical support and training staff of Budget department | $$ |
| | | Revise budget instructions | Heads of line ministries; Budget Director, MoF | June 2019 | Revised budget instructions setting out: budget timetable aggregate and ministerial budget ceilings; instructions for preparing detailed estimates | Not required | No additional cost |
| | | Update financial management legislation and/or regulations to strengthen legal requirements for adherence to aggregate and ministerial budget ceilings | Heads of line ministries; Budget Director, MoF | June 2021 | Draft revised financial management legislation and regulations (June 2020)<br><br>Revised financial management legislation approved by parliament (June 2021) | TA support for drafting new financial management legislation | $$) |

In some cases, a government's approach to reform may be less structured and more piecemeal based on individual (and achievable) reform initiatives. Specific problems may be responded to in a more ad hoc manner or simply reflect what is considered achievable given a particular set of circumstances (depending on the political environment, the skills capacity available or the institutional framework). Such circumstances may not lend themselves to a formal work plan. It is nevertheless important to be clear on what the objective of a reform may be, what actions are required, who is responsible for working on the reform and when the reform is expected to be completed.

Capacity development takes time and, is often non-linear. Content and approach to capacity building will have to be adjusted over time reflecting on impact and unintended consequences. Special attention should be given to the effectiveness of one-off training as opposed to building of country institutions to facilitate ongoing capacity development using country institutions.

It is recommended that work commences on developing the action plan (and/or identifying the specific reform initiatives and tasks) as soon as possible after the PEFA report has been completed. . The organizational set-up for this work should reflect the circumstances of the country. One approach could be to anchor this with a high-level meeting of senior government officials with a PEFA Oversight Team set up for the PEFA Assessment and all the main stakeholders participating in the PEFA report dissemination workshop.

## Stage 7: Monitor and evaluate reform implementation

**10) Are reforms being implemented?**

Progress on implementation should be monitored against specific reforms, actions, milestones and deadlines, as well as for the potential impact on PFM performance as measured by the relevant PEFA performance indicator(s) or dimensions.

Monitoring should be used continuously for learning and adjusting objectives, actions and risk mitigation. Whether reforms are implemented through a structured, iterative or unstructured approach, it is important to track the actions undertaken and deliverables achieved and to hold accountable those who are responsible for carrying out the tasks involved.

Full implementation of a PFM reform task may take several steps over several years; PEFA indicators and dimensions may, therefore, not always be suited for measuring progress over the short term. There is also a distinction between monitoring implementation of the reform and the impact of that reform. Evaluation of longer-term periods should also address the efficiency and effectiveness of the reform and its impact on the three main budgetary and fiscal outcomes – aggregate fiscal discipline, strategic allocation of resources and efficient service delivery which is discussed further below.

Successive PEFA assessments, and/or other diagnostic tools, can be planned after three or more years to take another cross-sectional snapshot of progress across the entire PFM framework. In this way, PEFA, and/or other diagnostic tools, can be integrated into the government's monitoring and evaluation (M&E) system with respect to its overall reform program. It is also important, therefore, that those tasked with implementing reforms provide regular progress reports to those responsible for monitoring progress. In turn, the officer responsible for M&E, should prepare regular quarterly or half-yearly updates for the government to ensure that the PFM reform process is ongoing, transparent and accountable.

Some PFM reforms are not suited to annual monitoring due to considerations of cost and complexity or where it is unlikely that there will be significant change over a relatively short time. Many PFM reforms can take several years to implement to the extent that they will affect PEFA dimension or indicator scores. Nonetheless, many new governments consider that having a PEFA assessment early in their appointment is a useful check on the status of PFM and serves as a benchmark for reform initiatives.

**11) What are the next steps for reform?**

PFM reform is rarely linear in its application. Reforms can encounter constraints and progress can be variable. Governments may need to respond to those constraints and continually adjust their reform plans.

The success or failure of a reform initiative will determine the next steps in the reform process. Failure or partial success will require governments to evaluate the factors that have affected success or failure. Further impediments to reform that have been identified should be addressed. A lack of success may be due to poor or inadequate program design. Practitioners may need to try several iterations of design before a reform is successful. If reforms are successfully implemented, the government and development partner should move on to the next priority and apply the same approach. In our example, there may be several attempts at developing economic models and fiscal forecasting techniques that produce sufficiently robust fiscal forecasts

## 12) Has reform had the desired impact on the identified problem?

The final question is whether the reform has had the desired impact on the identified problemSo, while specific tasks and deliverables should be closely monitored, the reforms should be evaluated to determine whether they have had the desired impact on the PFM weaknesses previously identified and addressing any broader policy problems that may have been the initial catalyst for the reform. It is important to look beyond just the PFM impact—not only in terms of the form and functioning of the PFM institutions and systems, but also the impact on the improved PFM performance on the three key budgetary outcomes: aggregate fiscal discipline, strategic allocation of resources and efficient service delivery.

In the example of the matrix used throughout the six stages, the government would evaluate how implementation of the three reform priorities has impacted on its desired outcome – aggregate fiscal discipline. The evaluation may show that implementation has been successful and has had an impact but that additional reforms are required to strengthen fiscal discipline further.

**Box 2.2 Form vs Function**

PFM reforms have been criticized for producing "…administrative systems in developing countries that look like those of modern states but that do not (indeed, cannot) perform like them…." (Andrews et al, 2017). While there is no doubt that, in some cases, there has been too much focus on the form of PFM (and in some cases in such complex form that is beyond the capacity of the countries to absorb and implement), it is nevertheless, difficult to reform function without first putting in place the necessary laws, regulations and processes to support that ---reform. It is stating the obvious that countries and their development partners need to ensure reform of "function" as well as "form" of PFM systems. In many cases, establishing the form is an essential pre-requisite for implementing the function. It is not that a focus on form per se is bad; rather it is important to follow up on the implementation of form with adherence with function. This often requires intensive and, importantly, sustained technical assistance and support for capacity development.

A review of contemporary literature suggests some dissatisfaction with how the reform design process has worked in the past. Once the stakeholders have been identified and their motivations understood, the decision process should focus on reaching an agreement between different stakeholders on defining the limits of reform, agreeing with donor partners on the overall reform strategy and ensuring the authorities are fully aware of the implications of, and fully committed to, the reform. Somewhat in contrast to this rather idealized view of how the decision process should function, in the real world there are obvious complications, which are summarized below:

- *Reform activities are too broad and overly ambitious in scope.* There seems a built-in bias in the PFM area to be over-optimistic about what can be achieved and to underestimate the time required. This also seems a common feature of large-scale public projects.

- *Donors' assistance to PFM remain rather homogenous despite continuous effort to tailor the reform to country needs.* Despite continuous efforts to tailor the reforms to country needs, and despite donors' insistence that reforms should be led by the authorities and answer their perceived problems, this is not always put into practice. For instance, Andrews found a disturbing similarity in reforms being pursued in Africa, regardless of different country contexts and different stages in their PFM system development. This he put down to bureaucratic agencies being biased toward what has worked in the past or what they are familiar with—in his phrase "institutional isomorphism."3

- *Fritz et al. (2017), also found that reform packages targeting PFM reforms remain rather homogenous:* they include a list of about 10 items: Medium-Term Expenditure Frameworks (MTEFs) and program budgeting to achieve a better policy orientation of budgets; introduction of new budget classifications and accounting standards (including in many countries, the ambition to shift to International Public Sector Accounting Standards [IPSAS]); establishing and upgrading information technology (IT) systems for managing public expenditures; better cash management, including the introduction of Treasury Single Accounts (TSAs); strengthening internal audit and external audit; and ex post accountability. Reform packages typically focus on a selection of this set and, in some cases, most or all of these areas. The considerable homogeneity of reform intentions, also reflected in the five case studies (Nepal, Tanzania, the Philippines, Georgia, and Niger) on which this conclusion builds shows that there may be problems with adequate tailoring of reforms to a country's context.

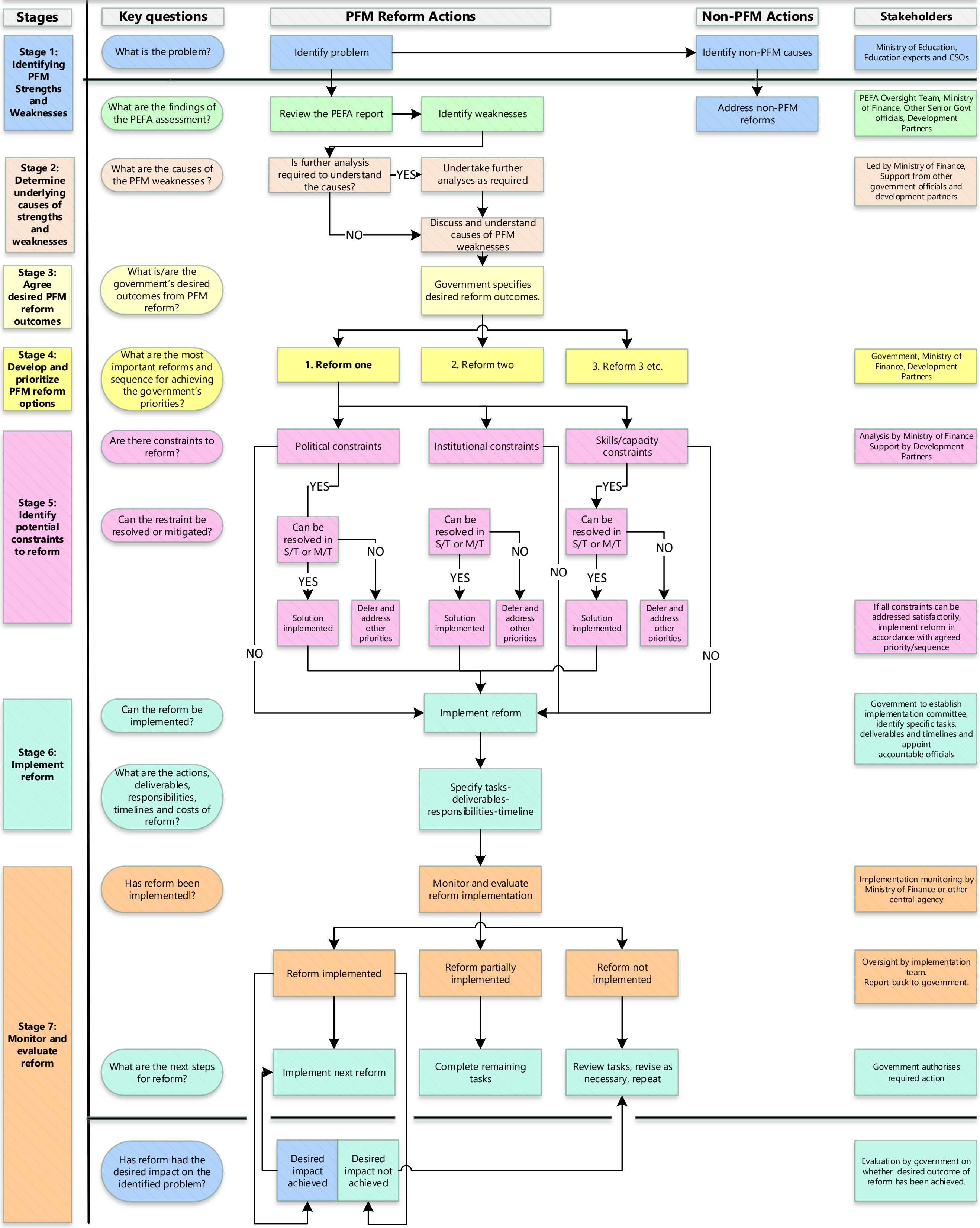
- *There is a bias to agree to donor proposals in decisions in which political benefits (and resources) come up-front and costs (if any) much later.* Part of the explanation for the previous concerns arises from the way local authorities enter into dialogue with donors. Given the usual political cycle, the time horizon of the politician's term tends to be shorter than that of the donors. Resources come first and, given the nature of PFM reforms, results occur only after a considerable time. On the other hand, donors want reform programs and they stress the importance of the local authorities to lead and drive the reform. However, how the political commitment is evidenced and sustained deserves more consideration in the design of reform programs.

- *Choosing reform activities on the basis of local demand also has its downside*. Getting the authorities to own and lead reforms is essential, but if taken too far in some contexts this could prove risky and may involve PFM trade-offs. Given the already stated concerns, donors should perhaps more explicitly re-examine how far technical PFM considerations should be compromised to fit a country's political economy context

Others have advocated more radical approaches of questioning whether a particular PFM area is actually reformable in certain circumstances and therefore whether it is desirable to keep allocating resources without the required enabling factors in place. This highlight both the capacity for reform and ensuring that reform initiatives are implemented with the appropriate and optimum sequencing. Woodcock et al. (2017) analyzed experiences with public sector reform, including PFM, based on case studies in eight countries in East Asia. These studies focused on three key areas that affect the success or failure of reform: design quality, political environment and institutional capacity. This approach provides a useful basis for developing PFM reforms following a PEFA assessment and subsequent PFM reform dialogue.

[3] Isomorphism implies that common reforms are presumed to provide a rational means to attain desirable ends—especially organizational legitimacy in external settings (Andrews, 2010, p.53)."

**Figure 2.1. A practical guide to PEFA and PFM Reform Dialogue**



# 3. Planning for reform

## Deciding the right approach

Based on the seven stages approach outlined in  section 2, the reform dialogue is intended to lead to a set of desired PFM outcomes around which the government's reform priorities can be agreed and initiatives developed to address weaknesses identified in the PEFA report (supplemented by further analysis as required). What happens next will largely depend on the country context.

| Comprehensive program | More open-ended, less structured |
|---|---|
| In some cases, it will make sense t to develop a comprehensive program of reform initiatives that is formalized into a new (or revised) PFM reform strategy or action plan. More comprehensive reform strategies or action plans are most appropriate in circumstances where the government has had previous experience successfully developing and implementing reforms, where existing capacities are good or where the government has established an agreed-upon PFM capacity development program with development partners. | In other cases, a more open-ended, less structured and iterative reform approach focused on specific high-priority problems may be more appropriate. This might be the case where reform action plans have been developed in the past without any impact, where commitment to reform has been variable over time and where the causes of unsatisfactory performance and progress are not well understood. In these cases, smaller, less ambitious iterative reform initiatives with a focus on continuous feedback and learning may be more effective. |

Many experienced practitioners tailor reforms to country circumstances or apply a system of "trial and error" in reform design and implementation focusing on reforms that address the government's main problems and priorities and that can be implemented. Andrews et al (2017) proposes a similar approach referred to as "problem driven iterative adaptation".  However, for many countries, governments and development partners have often preferred a comprehensive reform strategy over a more iterative approach. This often leaves countries "weighed down" with multiple reform initiatives that strain country capacity, undermine political commitment and often result in "reform fatigue'." Nevertheless, even in settings where an iterative approach is more appropriate, there are benefits in setting out initiatives in a structured, albeit simplified reform and task plan.

**Box 3.1. Similarities in PFM reform projects**

Despite continued efforts to tailor the reforms to country needs, and despite donors' insistence that reforms should be led by the authorities and answer their perceived problems, in practice this is not always evident. For instance, Andrews found a disturbing similarity in reforms being pursued in Africa, regardless of different country contexts and different stages in their PFM system development. This he put down to bureaucratic agencies being biased towards what has worked in the past, or what they are familiar with—in his phrase "institutional isomorphism."[4]

Fritz et al. (2017), also found that reform packages targeting PFM reforms remain rather homogenous; they include a list of around 10 items: Medium-Term Expenditure Frameworks (MTEFs) and program budgeting to achieve a better policy orientation of budgets; introduction of new budget classifications and accounting standards (including in many countries, the ambition to shift to International Public Sector Accounting Standards [IPSAS]); establishing and upgrading information technology (IT) systems for managing public expenditures; better cash management, including the introduction of Treasury Single Accounts (TSAs); strengthening internal audit and external audit and ex post accountability. Reform packages typically focus on a selection of this set and, in some cases, most or all these areas. The considerable homogeneity of reform intentions, also reflected in the five case studies (Nepal, Tanzania, the Philippines, Georgia, and Niger) on which this conclusion builds that there may be problems with adequate tailoring of reforms to the country's context.

## Further guidance on prioritization and sequencing

The literature unfortunately provides very little practical guidance on how a government should decide on which areas of PFM it should prioritize in preparing its PFM reform strategy. The most concrete advice—on getting the basics right—by Allen Schick, focusses more on horizontal sequencing than vertical sequencing. The literature, however, has largely drawn a blank about the issue of selection—what a country should choose to do first, second and third—and what criteria are relevant here. Should improving cash management be given priority over establishing a TSA, or vice versa? Should eliminating spending arrears be given priority over building capacity in macro-fiscal forecasting and analysis? What degree of priority should be given to upgrading the legal framework for public finance and budgeting? These are important questions on which 101 different answers can (and often have) been given, most of them based on loose or missing criteria.

While not pretending to establish a rigorous analytical framework for answering the question of how to prioritize and sequence reform, this guidance provides general guidelines and criteria that may help narrow down the possibilities and organize the subsequent dialogue, by bringing together the key stages set out in Section 2.

Stage 1 will analyze the latest PEFA assessment report and identify the weak areas of performance. While a mechanical approach to selecting "weak" areas of performance based on a simple ranking of the PEFA scores should be eschewed—for reasons well-rehearsed in the literature—useful information can be derived. The assessment should be compared with previous PEFA reports (if available) to establish whether a consistent pattern of relatively weak performing areas emerges, and comparisons with other front-line diagnostic assessments such as TADAT, FTE and PIMA reports, as well as relevant TA reports from the IMF, World Bank and other credible sources should also be made, where these are available.

Stage 2 will draw on the assessment of the causes of the poor performance. In many cases, there are likely to be several causes behind an indicator under-performing (for example, PI-14 Macroeconomic and fiscal forecasting) which could be linked to technical capacity, lack of suitable IT systems to produce economic modelling, or political override. Existing diagnostic analyses of the country may not provide sufficient information to assess the causes of inferior performance in all cases and where this is the case, the guidance recommends further analysis. Having a better understanding of the underlying causes will enable countries and their development partners to identify which of these can be addressed and in what timeframe. Some of the underlying causes (technical or process oriented) may be resolved quickly; others, particularly, longstanding political constraints, make take significantly longer or, as discussed in section 2 may not be able to be overcome at all in the short or medium term.

Stage 3 requires an understanding of a government's desired PFM reform outcomes. For most developing countries, two major objectives of fiscal policy will be to strengthen fiscal discipline and to improve the credibility of the annual budget. In relation to the PEFA framework, this narrows down the focus quite substantially. Other areas of PFM could of course still feature as priorities, subject to further analysis discussed below. During this stage it is important to ask what comprises a country's overall strategy for fiscal policy and PFM. For example, are there any documents published by the government—such as budget speeches, or a fiscal strategy statement, or a PFM reform strategy—that define such policies or strategies? If a country has a program with the IMF, its overall policy objectives may also be enshrined in the program documents, which could include specific benchmarks such as a commitment to produce a new budget law or fiscal rules or to bring spending arrears under control. Such documents may be useful in identifying a country's short term or medium-term PFM reform priorities.

Stage 5 should assess the possible obstacles (technical, institutional or political) to making improvements in the areas identified. As set out in section 2, a template could be prepared, based on this analysis, which identifies the areas of reform that should potentially be allocated high priority, with observations about whether the reform is likely be relatively easy to achieve, moderately challenging, or extremely challenging. Only those areas in the first two categories should be given further consideration.

Even with the filters applied in the stages of prioritization described above, the process is likely to result in a large menu of "high priority" reforms. There is some justification for this outcome since in most developing countries, almost by definition, many PFM areas are relatively weak compared to the PEFA benchmarks. However, an approach which allows all such areas to be included in a country's PFM reform strategy leads to the overly detailed strategies which are commonplace in developing countries. This leads to both unrealistic expectations of what can be achieved in a particularly timeframe and, consequently, often unfair perceptions of failure as reform programs exceed the capacities of countries to implement. Under-execution (or non-execution) of many or most of the projects included in these strategies is frequently observed. Further filtering may thus be required to bring the selected list of projects down to a manageable size that aligns well with a country's fiscal and political priorities. This stage is likely to require more input from senior managers and politicians than from technicians.

In practice, history suggests that countries at any level of development are not able to manage successfully more than one or two major reform projects at one time. In practice, however, it has proved difficult to persuade development partners—many of whom are focused on pursuing their own perceived objectives for achieving good development outcomes and disbursing resources through their ODA programs—of the virtues of a lean and focused PFM reform strategy.

The last step of prioritization and sequencing (stage 5) should engage in a dialogue with senior government officials and (ideally) political leaders to discuss the analysis and agree on a set of reform priorities based on the preceding analysis. This dialogue can take many forms.

## Managing change

**Change management and the political economy of PFM reforms are related, but cover distinct aspects of reform authorization, implementation, and effective use.** Change management refers to the "process of -- helping people understand the need for change and to motivate them to take actions, which results in sustained changes in behavior" (World Bank, 2015). The process is important, as the introduction of new ways of working will only deliver results if they are widely accepted and actively utilized, rather than resisted or circumvented. While change management ideas have originated in the private sector, they have also been applied to public sector organizations, with most observers noting some specificity (Van der Voet 2014 and Kuipers et al. 2014).

**Depending on the level and solidity of political commitment to PFM reforms, it is then sensible to design a reform strategy that corresponds to the relative "window of opportunity" and a change management effort (Fritz et al., 2017).** Change management entails deliberate efforts to communicate effectively within affected organizations on why a certain change is being made, what to expect in terms of sequencing of reform steps, setting out what training will be needed and offered, and so on. This is particularly relevant for reforms that affect many staff and how things are done; for example, the introduction of a new accounting system or of large-scale IT applications. When rolling out changes to procurement systems, this type of change management may also involve nongovernmental stakeholders, for example, suppliers.

**Change management literature acknowledge five important areas for promoting effective change.** A recent World Bank Policy Research Paper, *Change Management That Works: Making Impacts in Challenging Environments* (Hughes et, 2017) identifies five areas, acknowledged in the change management literature, as essential for promoting effective change: leadership; project governance; engagement and communication of stakeholders; workforce enablement; and organizational realignment.

**All practitioners acknowledge that leadership is essential for implementing PFM reforms.** Gill notes that "leadership of successful change requires vision, strategy, the development of a culture of sustainable shared values that support the vision and strategy for change and empowering, motivating and inspiring those who are involved and affected" (2003, p. 307). However, Hughes et al, acknowledge that formal statements of support for a change program are not sufficient but rather that change must be articulated in a way that is understood by those affected by the change '*in terms of normative frames of reference shared between themselves and their subordinates*'

**'Project governance that reflects the local political economy context can help to ease the implementation of the change program (**Hughes et al). This means that decision-making for PFM reform needs to be made locally by those that have the power to mandate action and hold to account those responsible for implementation. Decision-making at the wrong level can result in difficult challenges of coordination or resourcing impacting on implementation.

**Engagement and communication with stakeholders is about ensuring those affected know about a change (i.e. reform initiative) and are willing to accept the change**. That the first condition is met, does not necessarily automatically lead to the second. Rather change has to be seen as beneficial to both the proponents of reform as well as those affected by the reform. This requires open and continuous dialogue between parties as well as and empathy and flexibility of the proponents of change in responding to the legitimate concerns of those affected by the change, including refining reform initiatives.

**Organizational alignment refers to the process by which organizational practices are reoriented to reflect the new way of working.** This may involve a change in work practices, organizational structures and job descriptions (in terms of the types of skills and competences required to implement the form.

**The last element highlighted by Hughes et al, workforce enablement is generally referred to in the literature as training in the application of new processes and systems or as referred to earlier in the guidance, capacity development.** Hughes et al also noted that the term can also be viewed more broadly as '*representing a level of confidence and familiarity with new processes, systematic learning, and an acceptance of new ways of doing things as appropriate and valid means of achieving common goals*'. Workforce enablement is essential if PFM reform and improvement is to be successfully adopted and embedded.

As we progress through the stages of PFM reform and improvement outlined in this guidance, it is important to be mindful of the need to manage change in the context of these five elements if implementation and PFM improvement is to be successful. Users should consider other guidance materials available to develop and/or support their approach to change management including the World Bank publication *Managing Change in PFM System Reforms, a Guide for Practitioners* 2015 and the World Bank policy research paper by Hughes et al referred to above.

## Pilot testing the application of Volume IV

The PEFA Secretariat is planning to pilot test the application of the guidance of Volume IV in selected volunteer countries.  Lessons learned from the pilot testing will be incorporated into the final published version of the guidance.

A draft Concept Note for pilot testing is presented at Annex 2.

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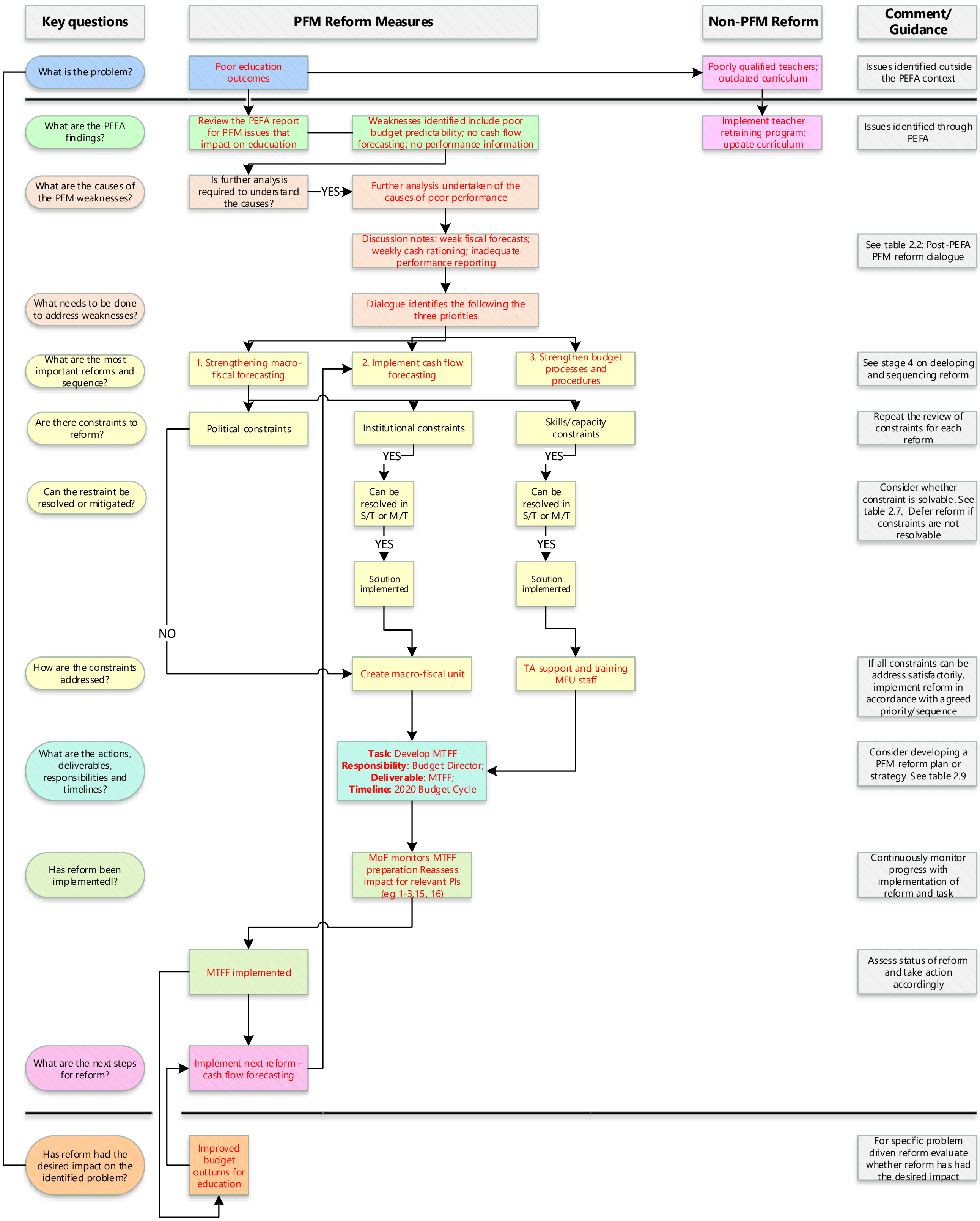
# Annex 1. Example of Flowchart for Reform Design



# Annex 2: Concept Note for Pilot Testing PEFA Handbook Volume IV

**Purpose**

This concept note sets out the management arrangements, scope of work, resource requirements and proposed deliverables for pilot testing the application of Volume IV of the PEFA Handbook with selected volunteer countries. Volume IV aims to support countries to use the findings from the PEFA assessment to help to develop and implement such PFM reform initiatives. While it does not provide a "one size fits all", it guides countries through a series of stages and key questions to identify the issues and challenges that should be considered in the process.

**Background**

Many countries and their development partners aim to use PEFA assessment reports for anchoring a PFM reform dialogue and as an important input to develop/redesign PFM reform strategies or engagements in order to improve the performance of their PFM systems. The objective of Volume IV of the PEFA Handbook is to provide guidance on how to do that. The Volume is intended to be a guide for countries on the issues that need to be considered in developing/redesign effective reform initiatives, strategies or action plans, designed to address each country's unique situation.

The PEFA Steering Committee has approved to pilot testing the application of the guidance set out in Volume IV in selected volunteer countries, subject to the agreement of the government and development partners. The pilot testing will involve in-country training on how to approach the development/redesign of PFM reforms following the completion of a PEFA report. Work will be undertaken with government officials, development partners and other stakeholders to provide guidance and facilitate the PFM reform dialogue, and subsequent development/redesign of effective PFM reform initiatives or action plans.

**Management arrangements**

The process of developing/redesigning PFM reform initiatives or action plans will be led by the Government. The Government is expected to nominate a counterpart with appropriate authority to lead and manage the process, including organizing training, facilitating meetings with stakeholders and developing, approving and monitoring PFM reform initiatives and action plans.

As part of the pilot testing, the government will be provided guidance and support on the application of key stages set out in Volume IV, including training and facilitation support for convening meetings of PFM stakeholders. The process can be supported by development partners, by consultants or by the PEFA Secretariat depending on in-country circumstances. In cases where the PEFA Secretariat is not directly involved in the in-country process, the Secretariat can provide remote guidance and online support.

**Scope of work**

Good PFM performance is determined by the ability of the PFM systems to support the effective and efficient achievement of policy objectives while maintaining macro-fiscal control as measured by the three main fiscal and budgetary outcomes: aggregate fiscal discipline, strategic allocation of resources and efficient service delivery. The PFM reform dialogue will:

(i) Be driven by government officials and involve other national stakeholders and development partners.
(ii) Use the PEFA report to identify PFM strengths and weaknesses and their impact on PFM performance.
(iii) Identify whether further analysis is required to identify the underlying technical and non-technical causes of PFM performance as reflected in PEFA scores and their impact.
(iv) Identify key factors to consider when designing PFM reform initiatives, action plan or strategy to address PFM weaknesses over time including for example, political environment, institutional and technical capacity.
(v) Facilitate prioritization and sequencing of PFM reforms in accordance with country needs and capacities.

Volume IV of the PEFA Handbook has been designed to support these processes. However, is not intended to be prescriptive in setting recommendations on reform priorities or sequencing. Rather, it is intended to provide a guide for countries on the issues that need to be considered in developing/redesigning effective reform initiatives, strategies or action plans, designed to address each country's unique situation. In this context, it will also be important to take stock of all analytical work from the development partners and the country's important development strategies and other important documents, in order to fully understand the country's context, reform priorities and technical and non-technical constraints as well as opportunities to reform. It also does not mean discarding existing PFM reform/improvement strategies where these exist, but rather building on those reform elements that have succeeded (and the lessons from that success) and addressing those that have not been so successful (and similarly the lessons on why these reforms have not been successful).

While the PEFA Secretariat is available to provide guidance on how to use PEFA assessments, including training workshops to facilitate PFM reform dialogue and action planning, it will not provide direct technical support for implementing PFM action plans or specific reform initiatives.

Two options are proposed for the pilot testing. Both options will involve the Secretariat providing training and follow-up guidance to assist countries develop/redesign PFM reform initiatives and/or action plan tailored to their specific circumstances.

***Option 1*** will involve a two week in-country mission during which it is expected that relevant government officials will develop a PFM reform plan for submission to the government. Training based on the approach outlined in Volume IV will be provided to all stakeholders nominated by the government. Training will be followed by meetings with key government officials, relevant development partners and other stakeholders. These meetings will be focused on specific issues arising from the PEFA assessment report. While the exact format of the meetings will be subject to discussion and agreement by the government prior to the mission, it is likely that these will focus on key and related aspects of the PFM system.

A summary of the key tasks envisaged is set out in the following table:

| Number | Task | Objective/Description | Stakeholders/Attendees |
|---|---|---|---|
| 1 | Meeting with Minister of Finance, heads of key government agencies, and development partners | Ensure consensus regarding purpose, scope and expected deliverables of the pilot testing and mission | Heads of agencies including: finance, treasury, accountant-general, revenue agency, national audit office.<br>Local representatives of development partners |
| 2 | Training of government officials on application of Volume IV | Ensure that there is a good understanding of the PEFA findings and the underlying methodology of using Volume IV to inform PFM reform dialogue and action planning | Senior and other relevant government officials.<br>Local representatives of development partners |
| –3 | A series of meetings of government officials grouped by either by pillar or key PFM function e.g. budget prep, audit etc. | Within each key area, officials would identify:<br>• Main weaknesses identified by the PEFA report (and other reports and analyses)<br>• Further analysis undertaken (or to be undertaken) to identify underlying causes of performance<br>• Main reform priorities (within each group)<br>• Potential constraints to reform and mitigation strategies<br>• Proposed reform initiatives and key tasks<br>• Monitoring arrangements<br>• Capacity development needs | Senior and other relevant government officials. |
| 4 | Meeting of heads of agencies to agree reform priorities, constraints to reform and strategies to mitigate these, and a sequence list of potential reform initiatives (and timelines) for consideration by Government. | Heads of agencies would discuss and review priorities identified during the 'PFM function' meetings and agree a consolidated set of priorities based on the above sub-headings (bullet points).<br>Allocate responsibilities for each reform or task.<br>Agree prioritized capacity development needs. | Heads of government agencies |
| 5 | Government lead officials prepare, with assistance of PEFA team, a draft reform plan or strategy | Reform plan or strategy would follow format set out in Vol IV | Lead government officials/ |
| 6 | Exit meeting with Minister and/or senior officials to present draft PFM reform action plan or strategy | To agree PFM reform initiatives or action plan, key tasks and responsibilities. | Minister, heads of agencies, development partners. |

It is important to emphasize that reform initiatives, priorities and sequencing will be driven by the government officials. Other stakeholders, including development partners will participate in this dialogue. The role of the Secretariat (or its engaged consultants) is to facilitate the development of the action plan by providing guidance and support.

***Option 2*** will involve two separate phases. This will include an initial training phase in which training based on the approach outlined in Volume IV will be provided to all stakeholders nominated by the government (as with option 1). As part of this training, government officials will develop an initial prioritized reform work plan to discuss and agree with key stakeholders within government and development partners. Unlike option 1, the PEFA Secretariat would not facilitate these meetings. Nevertheless, the Secretariat will provide remote assistance as required.

Under option 2, tasks 1 and 2 would be undertaken during the in-country mission including initial coaching of relevant government officials on subsequent activities. Tasks 3-5 would be undertaken in-country by government officials and development partners. If required, the Secretariat could support task 6 in-country or remotely via video conference.

It is expected that both options will be trialed during pilot testing, depending on the preferences of the volunteer governments.

For both options, periodic surveys of reform progress will also be undertaken by the Secretariat. A simple questionnaire will be developed that will monitor development and implementation of reform initiatives, including strategies to mitigate constraints and any commitments to technical support provided by development partners. The survey will aim to assess progress of the reform initiative and its impact on the three main budgetary outcomes.

**Resource requirements**

For option 1, it is envisioned that a PFM reform dialogue will need to be facilitated by two full time Secretariat team members (staff and/or contracted consultants) for the duration of the mission.

Option 2 would provide initial training and support facilitated by two Secretariat team members. The Secretariat would provide remote follow-up support to government officials as required during the development of the dialogue, reform initiatives and action plan. If required, a short follow-up in-country mission would facilitate discussions and finalization of draft reform initiatives, plan or strategy.

Actual funding will be determined on a case-by-case basis.

**Deliverables**

The engagement will produce the following deliverables:

(i) Training on application of Volume IV guidance for government officials involved in PFM reform planning and implementation.
(ii) Support to government officials to facilitate dialogue within government and with stakeholders on priorities, sequencing and resources for a PFM reform strategy or action plan
(iii) Agreement on arrangements for monitoring and evaluation of the implementation of PFM reforms and their impact.

**Desired impact**

The desired impact of the pilot is to assist governments develop and approve a PFM reform action plan setting out stakeholder agreed PFM reform initiatives, tasks, responsibilities, monitoring arrangements and timeframe for implementation for submission to government.