Background Paper 1:

Sequencing PFM Reforms

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ABBREVIATIONS AND ACRONYMS

FMIS	Financial Management Information System
GPN	Good Practice Note
IPSAS	International Public Sector Accounting Standards
LIC	Low Income Country
MDA	Ministry, Department and Agency
MOF	Ministry of Finance
MTBF	Medium-Term Budget Framework
MTBO	Medium-Term Budget Outlook
MTEF	Medium-Term Expenditure Framework
MTFF	Medium-Term Fiscal Framework
MTFO	Medium-Term Fiscal Outlook
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management

PREFACE

This document has been prepared as a background paper to the Good Practice Note (GPN) in Sequencing PFM Reforms, and should be read in conjunction with Background Paper 2, "Core PFM Functions and PEFA Performance Indicators" by Daniel Tommasi. The GPN summarizes the contents of both papers.

This work, which commenced in 2010, was in response to a request from OECD DAC for a Good Practice Note (GPN) to assist donors when sequencing PFM reforms. It was felt that although the planning of the technical aspects of individual PFM reforms appeared well understood, and agreed among donors, often the impact of reform programs was less than might be expected due to failures in the coordination and sequencing of reform actions. Consequently, the GPN is primarily targeted at those in the donor community, and their principal country counterparts, that are engaged in the design of PFM reforms.

At the outset, some points should be stressed. The GPN, as its name suggests, is an attempt to document the lessons learned in sequencing PFM reforms and, based on this, to offer some guidelines to assist future reform efforts. As such, it should not be regarded as providing a rigid prescription for reform sequencing and is certainly not a "how-to-do" manual for PFM reforms. The GPN does recommend a high-level ordering when undertaking reforms, beginning with establishing some key or "core" functions (stressing control over public finances) and then moving to more sophisticated reforms—establishing instruments for medium-term fiscal management and ultimately reforms aimed at improving efficiency and effectiveness in resource use. However, this in no way implies defining a universal reform path that all countries should follow. Rather, the GPN emphasizes that choice within broad reform categories should be country-specific, especially since all countries face different non-technical determinants external to PFM that are recognized in the GPN as critical to the success of reform. It is also recognized that typically reforms are not undertaken from a zero base, but must in some way accommodate on-going reforms. Accordingly, the GPN offers a possible analytical framework to address these diverse factors and to integrate them into country-specific reform sequencing decisions using a risk-based approach. In this way, the GPN should be regarded as only a first step in improving one aspect of the design of future PFM reforms, namely that involving the order and timing of reform actions. Indeed, it is emphasized that the practical applicability of its recommendations would benefit considerably from, and should be modified in light of, further empirical work. In this regard the GPN concludes by identifying some of the more obvious areas for further analysis where development partners are encouraged to make a contribution.

I. The Approach to PFM Reform Sequencing

A. Chapter I: Sequencing PFM Reforms: The State of the Art

Summary: *This chapter reviews recent key contributions to the PFM sequencing literature, and critically examines some of the dominant views found there. In light of this review, it highlights common themes that emerge in the literature.*

Does Sequencing in PFM Reforms Have any Practical Meaning?

1. **Despite some recent attempts to agree a sequence in planning PFM reforms, a consensus remains lacking.** Indeed, some would deny the concept has any practical use. At first glance, both historically and across countries, the argument for a technical solution to sequencing PFM reforms seems weak. It has been pointed out that if we look historically at how advanced countries have advanced their PFM systems progress appears haphazard, spasmodic, opportunistic, and politically motivated. Certainly their reforms hardly could be characterized as technical exercises that would merit being called a planned sequence of events. Further, the vast differences in country context seem to suggest a common reform approach, or objective, is likely to be difficult to identify and has given rise to further doubts. How can PFM reform be generalized to agree a sequence if non-technical factors dominate? After all no country is exactly like another now, so why should it be in the future? Can all countries be viewed as being on the same reform path? Should reform sequencing be viewed as a process to ultimately attain current best, or even good practice, as defined by advanced countries, when experience shows that best practice is constantly changing? More fundamentally, does "best practice" have much relevance to the majority of countries?

2. **Although different advanced countries have taken different reform routes the end result has not been too different.** As a consequence the concept of "good" practice in PFM seems, if not in the details, to be broadly agreed. On this agreement international assessment tools, like PEFA, have been founded. Admittedly, while the advanced countries have reached similar end results, they have displayed a variety of paths and completely different time-lines in reaching these results. But this great variation does not mean that the experience of these pioneers is not relevant, and that others undertaking PFM reforms have nothing to learn from it.

3. **To be successful in PFM reform there is little choice but to attempt to define a desirable sequence of reforms.** It is admitted this paper takes a decidedly positive stance to the sequencing issue. If we cannot define at least a notional reform path, no reform can define what it is ultimately attempting to achieve, and certainly cannot define the steps to be taken on the way to achieving this. In the absence of this broad "vision" more detailed reform efforts, and the associated donor support, will tend to be band-aid, quick-fix, dealing with symptoms, and reforms will be difficult to sustain. Apart from the need to define the broad objectives of reform, the practical problems in implementing PFM reforms also suggest it is not possible to avoid the sequencing problem. PFM is a system so wide in nature that not all

elements can be tackled at once. This implies that, of necessity, reformers need to prioritize to pursue a viable reform path. How to prioritize lies at the heart of the sequencing issue.

A Review of the PFM Sequencing Literature

4. **This takes the "basics first" approach as a starting point.** In many ways it is difficult to differentiate the literature on PFM sequencing from the more general literature on the design of PFM reform programs. However, there are a few important recent works which directly address the issue of the order in which reform activities should be undertaken. In this subset, Allan Schick's1998 contribution, stressing the important principle of "getting the basics right" as a first priority when undertaking reform, has already gained wide currency. His was originally a plea for reversing what he felt were the over-ambitious attempts to establish PFM international best practices in less developed countries which lacked the capacity to operate even basic processes. His message was summed up succinctly in the World Bank PEM Handbook (see Box 1.1).

5. **However, the "basics first" approach has not proved popular.** Notwithstanding its broad endorsement by the majority of donor agencies,[1] this very simple message on sequencing, that low capacity countries should first focus on their basic PFM processes, has been surprisingly controversial for a number of reasons. First, it has been difficult for experts in the field to agree on what should be considered "basic", although there is a substantial degree of overlap in all interpretations.[2] Secondly, others have objected to designating any PFM process as "basic" as involving a large degree of arbitrariness, and hence the approach gives insufficient guidance to reform action.[3] Thirdly, that the concept of sticking to the "basics first" principle is not an easy strategy to sell within LICs, as well as within the donor community.[4]

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[1] Among them, DFID (2001,pp.46ff.), USAID (Browne, 2010,Chapter 5), ADB (Schiavo-Campo,1999,p.118ff), IBRD (1998).

[2] Compare, for example, the "basic" reforms identified by Tandberg and Pavesic-Skerlap, 2008, with Schick's checklist. See also, Tommasi, 2009, p.22, for his definition of "basics" versus "beyond basics", and Browne, 2010, pp.16ff, for a description of her interpretation of "first level" or basic reforms.

[3] Allen, for example, sees the concept of "basic" as subjective, as he puts it "it is similarly unclear what criteria should be applied in determining whether a country has achieved sufficient progress in improving its basic systems to move forward to more advanced measures. Should a government be encouraged to start work on such reforms before *all* the basics are in place? Are some of the basics more important than others in establishing essential preconditions for moving on to the menu of more advanced measures?" (Allen 2009,p.17).

[4] Allen and others have noted how unattractive the "return to basics" strategy can be for politicians knowledgeable about the latest reforms in advanced countries and eager to show results (Allen, 2009; Andrews 2006).

Box 1.1. The “Basics First” Approach

In elaborating his argument for “Getting the Basics Right,” Schick states:

- The government should foster an environment that supports and demands performance before introducing performance or outcome budgeting.
- Control inputs before seeking to control outputs.
- Account for cash before accounting for accruals.
- Establish external controls before introducing internal control.
- Establish internal control before introducing managerial accountability.
- Operate a reliable accounting system before installing an integrated financial management system.
- Budget for work to be done before budgeting for results to be achieved.
- Enforce formal contracts in the market sector before introducing performance contracts in the public sector.
- Have effective financial auditing before moving to performance auditing.
- Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

Source: Public Expenditure Management Handbook. IBRD. 1998.

6. **Alongside the “basics first” approach, and perhaps recently the approach that has gained wide interest, is the “platform approach”**. Associated with Peter Brooke (2003)[5], this strategy for sequencing PFM reforms proposes to replace of the past emphasis on individual reform activities. It argues that a more productive approach is to focus on reform activities packaged together. These packages of supportive measures then should form a logical sequence for reform, so that once one package of activities is completed it will form the basis, or “platform”, on which to anchor a further package of complementary reforms. This strategy is designed to advance the PFM system over a period, perhaps as long as ten years, with each platform’s activities lasting for a period of two to three years. The total strategy is envisaged as being up-dated and rolled over, say, every two years depending on progress made. There have been a number of arguments advanced in support of such an approach to sequencing reform. First, is the simply technical one—that some PFM processes are technically dependent on others being in place to ensure success.[6] Second, it provides a more structured approach to the planning and implementation of reforms that would help inform and coordinate the reform efforts of governments, IFIs and donors, i.e., assist greatly

[5] A variant of the platform approach is the so-called “evolutionary approach” developed for Ethiopia and implemented by Harvard University (see Petersen,2007). Although differing in content, this approach is little different in design than that advanced by Brooke.

[6] For example, it is difficult to develop an adequate external audit function, without an adequate accounting system in place. As such, the technical argument could be viewed as a variant of Schick’s “basics first” approach.

in change management.[7] Third, by sequencing into the medium term, the approach provides a "vision" of the end result[8] that, while it cannot be attained in the short-run, can be achieved by well identified smaller steps, again assisting in "selling" and sustaining the reform effort. Fourth, is the practical argument: moving step by step, and completing one step before beginning another, is more realistic in developing countries which are usually severely capacity and resource constrained.

7. **Although increasingly popular there have been some detractors of the platform strategy.** Some within IFIs, like the World Bank, have found the above arguments compelling, and have adopted the platform approach in support of large high profile PFM reform programs, such as those in Kenya and Cambodia.[9] However, there have been a number of criticisms, aimed both at the approach itself and how the approach has been applied.[10] First, some doubt the validity of technical arguments for identifying some processes as more important, on which other PFM processes depend, for inclusion in successive platforms.[11] Second, given each platform is an amalgam of various reform activities it has been argued that it is often difficult to agree with the definition and objective of each platform, or hence reach consensus on its achievement.[12] Third, the approach is often criticized as being overloaded in reform actions and over-engineered in design, hence difficult to manage, and therefore prone to failure and reform fatigue. It should be noted that as the approach has become more popular, the platform approach has also attracted criticisms that could be applied to almost all other reform strategies, and the term itself has perhaps been indiscriminately used as a way of packaging reforms to better "sell" them to donors and country authorities.

8. **There have been attempts to accommodate other approaches into the platform strategy.** Tommasi (2009), while broadly endorsing the platform approach, has made the case that most attention should be paid to the first platform of the reform process in terms of planning and implementation. For him, this first platform is the most relevant for most

[7]As Taliercio puts it, "given limited capacity, reform is broken into pieces for easier digestion" (Taliercio, 2010 p.19).
[8] What Schick calls "joining the dots".
[9] For a review and critique of both these programs, see Allen 2009.
[10] Note the warning by Schiavo-Campo, "Certainly, we need to think in terms of complementary packages of budgeting improvements—and to that extent the platform analogy is healthy and useful. But it is only an analogy, and if pushed too far into prescription it risks becoming dysfunctional…"Schiavo-Campo, 2010, p.7
[11] This is equivalent to the controversy over what constitutes "basics" in the "basics first" approach.
[12] As Richard Allen, so eloquently puts it: "If it is not possible to agree on a rigorous definition of the goals of the reform strategy that are being pursued—and a unique measuring rod for evaluating whether or not these goals have been achieved—then the whole concept of platforms becomes operationally meaningless, and collapses, much as a building or bridge would collapse if the architects and contractors could neither agree on how the foundations of that structure should be built, nor on a way of measuring when such work had been completed to the required specifications." (Allen, 2009, p. 18).

developing countries and should aim to ensure the “basics” are in place.[13] While admitting there is no agreed definition of the “basics”, he attempts for each sub-sector of the PFM system to separate “basic” from “beyond basic” priorities. To accomplish this he uses the PEFA analytical framework and associated indicators. For each of the PEFA indicators he delineates the desired rating, or target score, that would suffice to ensure a “basic” level is attained in the PFM process covered by that indicator. Consequently he takes the definition of basic PFM processes considerably further than that attempted by Schick. At the same time, he is less rigid from a sequencing viewpoint. The first “basics first” platform he sees as being dependent on the country context in a number of ways: since in all likelihood not all deficient basic areas can be tackled, the choice of basic reform priorities will be country specific;[14] interconnections between processes may depend on the country’s institutional context so priorities cannot be solely technically determined,[15] and, in terms of practicality, it may be necessary to incorporate on-going reforms that go beyond the basics.

9. **There have also been other approaches to using the PEFA framework to assist in sequencing decisions.** Another recent attempt to use the PEFA framework to assist in the sequencing of PFM reforms has been advanced by Quist (Quist, 2009). He adopts a broad platform approach founded on the stages in PFM system development, which he identifies with various PFM objectives: aggregate fiscal discipline;[16] efficient service delivery; and strategic allocation of resources. It is notable that his first platform delivering “fiscal discipline” is very close to what most previously discussed contributions would subsume in the “basics first approach”[17] He then uses PEFA indicators to define these platform capabilities. The novel part of his approach, he calls the “PEFA Reform Sequence Model Framework”, is to technically define the sequence of reform activities by looking at the inter-dependencies in the various PFM subsystem elements to identify the impact of each element on overall PFM performance, after taking into account the number of “broken” PFM functions (i.e., those scoring D, or N in PEFA rating) and the number of well functioning

[13] These basic measures are generally those “focusing on aggregate fiscal discipline, due process (including compliance), and minimum requirements for accountability and transparency” (Tommasi, 2009, p. 30).
[14] Although he does insert his own priority preferences in terms of priorities: for example, satisfactory budget coverage, adequate administrative and economic budget classification, clear accounting procedures and clear definition of the responsibilities in budgeting. (Tommasi, 2009, p. 26)
[15] He gives the example in developing countries where formal rules are properly designed but where informal arrangements and gaming with the rules are rampant. In this context there is no point in further amendments to the existing rules. Rather the priority should be increased transparency and improved external accountability mechanisms.
[16] It should be noted that objectives are defined in a systems context based on a simple input-output framework: input, generates activity that produces an output that produces an outcome, and the outputs and outcomes have feedback loops determining future inputs. Thus fiscal discipline us defined in theses terms: sustaining the function of the system; improving input controls and predictability; building activity capacity; strengthening output controls; achieving regular, timely and accurate feedback. (Quist, 2010).
[17] “The first step for reform must focus broadly on sustaining the function of the system. This translates into a focus on improving input controls and predictability, building activity capacity and strengthening output controls, and achieving regular, timely and accurate feedback”(Quist,2009, p.10).

activities (generally A and B rating). He uses the full PEFA 74 sub indicators to determine interdependencies. He reviews the backward linkages, to define what are called "activity chains", i.e., the number of activities that will have to be carried out to address the requirements for implementing a reform for any one given PI. These are regarded as the pre-requisites for reforming this PI, or "reform effort", that is measured by the total activity chain less those PIs that are functioning well. He also reviews the forward linkages, asking if a given PI were to be made fully functional how this would positively impact all other PIs, i.e., an indication of the PI's importance to the PFM system as a whole, this he calls "reform impact". His sequencing strategy is to opt for "fast wins" by choosing the PIs with the shortest activity chains first.[18] Note by employing a country's PEFA ratings as the basis of the model, his is a country specific approach to the determination of reform sequencing.

10. **Attempts to employ a purely technical solution to sequencing problems have been questioned.** It should be admitted that Quist's apparently technical approach to sequencing has met with some criticism.[19] The use of the "system approach" in this model framework often appears forced, but is necessary in order to define dependency within different PFM elements, and certainly the description of the model's derivation of activity chains and determination of the interdependencies could be disputed. Some purists would view a system as denoting that every element is dependent on the other, hence the idea of giving priority to one can be viewed as a distortion of the system model. Similarly, the use of PEFA indicators is not without problems. All 74 sub-indicators are treated equally, although some can be considered derivative indicators measuring the results of how other indicators are performing.[20] Moreover, since some ratings span different platforms they require some subjective allocation to different platforms. This is accommodated by his division of countries into two levels of PFM development: level one, operating traditional budgets devoid of program orientation; and level two, operating what he calls "a policy based" budget system. This leads him to treat the PEFA indicators differently in his model for the two groups, with at least some additional complications for its application.[21]

11. **However, while using technical criteria provided by PEFA, Quist recognizes the importance of non-technical factors when deciding sequencing.** Despite the initial

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[18] To assist in this sequencing exercise he constructs a sequence rating indicator that measures the priority of the PFM element due to its reform impact on the whole system. The sequence indicator is inversely proportional to "reform effort" and proportional to "reform impact". See Quist, 2009, p. 28.

[19] See, for example, Schiavo-Campo, 2010, p.5.

[20] See Tommasi, 2009,Annex II.

[21] Moving from one budget system to another (i.e., level one to level two) involves a structural change, what he refers to as a "foundational" reform rather than an "ordinary" PFM reform.. As he puts it, "when a country decides to transition from traditional budgeting to policy based budgeting it should not use its previous PEFA scores to determine the appropriate sequencing, but may be better served by adopting the base case to represent a degree of restructuring its entire PFM systems to accommodate the structural change" (Quist, 2009, p.18). This begs the question of what happens when the reform program is aimed at changing only some elements of the budget system from one level to another.

impression of Quist's model as being rather mechanistic and overly focused on technical aspects of PFM reform in its approach to sequencing, this is far from the case. While attempting to identify the most important PFM elements for reform by the importance of dependencies between different PFM elements, this analysis of PEFA indicators is not the sole (and perhaps not the most important) determiner of reform sequence. He explicitly introduces the time required to implement a reform as an important factor in sequencing—this he designates as "the roll out effort". This is viewed as dependent on the institutions responsible for carrying out the PFM activities, recognizing some activities are centralized, so roll out is limited, but other activities require many participants in the PFM system, and hence roll out effort becomes a critical consideration in sequencing. Moreover, Quist is very clear that sequencing should "like all change management, take into account a number of considerations: political as well as functional technical factors, and formal as well as informal institutional elements, capacity as well as governance structures" (Quist, 2009, p.7). Given the importance Quist assigns to these factors in his model, these would appear to outweigh the purely technical determination of PFM reform design. Indeed, Quist is quite explicit that his technical analysis should inform rather than determine reform sequence.

12. **The emphasis on the PEFA framework for sequencing decisions is also apparent in the work of Andrews.** Another recent study that reviews reform design primarily through the prism of PEFA indicators is Andrew's research on the effectiveness of PFM reforms in 31 African countries (Andrews, 2010). Although not the primary objective of the research, the study does throw some light on sequencing PFM reform, admittedly in this sub-group of countries. Using their PEFA scores, on all PEFA sub-indicators, he divides countries into five "leagues", (1-5), determined by their level of PFM development, from low to high. It is possible to interpret these empirically derived leagues as identifying "platforms" for PFM reform. He then asks: what would it take for low league countries to reach the scores of high league countries? He divides the PEFA dimensions into three: those in which the scores would be easiest to reach, (i.e., the nearest), he calls "low lying fruit"; those in which the scores are furthest apart, and hence would be the hardest to attain, he calls "high hanging fruit"; and those in the middle range, "middle lying fruit". In this way his analysis reaches a possible prioritization in the various PFM areas, identified by the PEFA indicators. Moreover, because most African countries are scoring in the "basics" range of indicators, this does offer an empirical approach based on country reform experience, to decide which basic functions should come before others in reform design. It is likely that the approach could be generalized, and if replicated in other areas of the world could also yield some interesting insights into sequencing priorities.

13. **There are some criticisms of this empirical approach.** There are a number of dangers in reading too much into the sequencing derived from this study. First and foremost, the order of reform activities is determined on the "ease" of implementation, not the impact of the reform action on the overall PFM system. The choice of reform actions may thus be biased towards reforms that require less discomfort to stakeholders or involve a few central stakeholders for success—criticisms that Andrews has leveled at previous reform

approaches. [22] Also, how countries are selected for the sample is important. His sample was determined geographically, but despite this he noted the importance of the considerable variation in the context in which reform took place. Andrews found significantly statistical differences in PEFA scores related to such external factors as: growth rates of their economies; social, political and economic stability; the share of non mineral income sources; the length of the period of broad reform commitment; and perhaps also, colonial heritage (e.g., whether Anglophone or Francophone budget systems were operated). He is aware that statistical association does not imply causality, or if there is a causal connection the direction of that causality is often uncertain.[23] However, perhaps he does not stress enough that reform may not be unidirectional, i.e., experience has shown that progress can be easily reversed in developing countries.

14. **However, once again the importance of non-technical factors is stressed.** It should be noted that, like other contributors reviewed previously, Andrews stresses the importance of country context and non-technical factors for success in PFM reform. Given this different inter-country environment, would it be legitimate or desirable that countries follow the same reform path? Andrews, himself, sees dangers in doing so. He is quite critical of the fact that the reform paths of these countries has been very much determined externally by the donors, through what he calls international "reform products", based on a same-size-fits-all strategy. Moreover, he is also critical of the content of these products and the longer run viability of the strategies being pursued. He notes, for example, that PFM reform has been distinctly more successful in the earlier stages of the budget cycle (upstream stages), rather than the budget execution stages (downstream). This is reflected universally in African PEFA scores, regardless of a country's league. This he sees as a by-product of these international reform products that have focused on changes in laws, regulations and processes, ("de jure" changes) rather than on changing behavior ("de facto" changes). In doing so, reform efforts have focused on a few central agencies like the budget department, treasury, revenue regulatory agencies, and central procurement agencies, etc. This he labels as involving "concentrated" PFM processes. The international reform products have tended to avoid those reforms that require changes to behavior that involve a large number of budget process participants (i.e., the "de-concentrated" processes). It is the latter processes, generally found downstream in the budget, he argues, that urgently require improving but also tend to be the most difficult to do so. In this conclusion he mirrors the importance that Quist assigns to the rollout effort discussed above.

[22] Discussed further in Section 7.
[23] These problems are magnified in cross country rather than time series studies.

What Does The Literature Tell Us?

15. **Despite the seemingly different approaches adopted, and the undoubted controversy that exists, there are some general themes that emerge in the literature**:

16. **Generally, the importance of sequencing in the design of PFM reforms is endorsed, but in different ways and to different degrees.** Almost universally experts in the field argue against the "big bang" approach, that attempts a broad range of reforms simultaneously in a short period of time. Rather they view an incremental or step-wise approach—or the sequenced approach—as more viable. This idea of the importance of the order in which reform activities are undertaken is the main thrust of the "basics first approach". It implies the first reform steps should aim to set up basic financial discipline through processes associated with a traditional budgeting model. In this way, the "basics first" argument tries to define what the first step in the reform sequence should be. However, to some the approach has often been viewed as rather negative, since the associated argument is that most LICs have a long way to go before they can even ensure the "basics" are in place, and hence by implication should shelve more modern reforms such as program and results-oriented budgeting techniques. The idea of sequencing reforms to ensure their success is perhaps most strongly stated in the so-called "platform approach", where improved integrated PFM processes can, once established, act as a solid basis for building the reforms of the next platform. While this has the advantage of taking countries beyond the basics, some see this as potentially dangerous, hence, critics such as Allen, question this sequenced approach as being too ambitious and doomed to failure.[24] However, it is also worth noting that there is nothing inherently contradictory in the platform and "basics first" approaches, if the first platform aims to establish "basic" PFM processes.

17. **There are some hints at an underlying contradiction in prioritizing reforms.** In much of the above discussion there seems to be an underlying contradiction in adopting the idea of sequencing PFM reforms: namely, is there an underlying tension between viewing PFM as a system, where all sub-systems are interlinked, and then choosing a sequenced approach where inevitably some subsystems are prioritized in the reform design? As indicated, some, such as Quist, try to relieve the tension by designating some subsystems more critical than others through an analysis of their linkages in the PFM system. In this way he attempts to define a country-specific sequenced approach to reform based on PEFA indicators. However, as indicated, some remain skeptical of this approach, not the least because the characterization of a "system" that underlies the concept of linkages is somewhat artificial, his heavy reliance on PEFA indicators that are not designed for this purpose, and the inevitable qualifications that have to be introduced into what some see as an overly technical approach to sequencing.

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[24] While Allen has been critical, it should be noted at the same time as eschewing the sequenced approach at the "macro" system reform level, he would see value in sequencing at the lower, sub-system level and identifies various areas where this has proved successful.

18. **While most experts in the field recognize the value of a sequenced approach, at the same time most would also agree to disagree on the desired order of sequenced reform actions.** The lack of harmony in the literature has been noted above. For example, the question as to what should the first platform encompass has been answered in different ways in different countries. This lack of consensus is most evident in the various interpretations on what constitute PFM "basics". Some define "basics" negatively as what they are not (see Schiavo-Campo, 2010, p.9).[25] Some have been bolder. For example, Schick's initial paper laid out his view of "basics", which appear to be in line with traditional budgeting fiscal discipline. But even this checklist, which seems innocuous enough, is not without its detractors. As noted, Tommasi has gone further, and in some detail, examining each PFM sub-system he has tried to define what would be "basic" PFM processes and what would be "beyond basics". However, in many ways this important exercise highlights the depth of the problem faced in reform design: even if we can define the first step in a sequenced reform as "basic", we would not be able to tackle all basic sub-systems at once, so how to prioritize between them? Are some basic processes more important than others? But if they are, (as Quist would argue), surely for the PFM system's viability as a whole there needs to be a balanced approach in reform. If one subsystem is advanced much further than the others is this reform likely to be as effective without the support of other subsystems? This, after all, is the logic of the platform approach.

19. **It should be noted that most experts in the field are willing to accept the PEFA framework as a method of assessing effectiveness in PFM reform programs.** Some, (like Tommasi and Quist), have turned to the PEFA indicators to identify which indicators best reflect what the "basics" should be and to use the ratings of indicators to prioritize reform efforts. Unfortunately, PEFA indicators on many dimensions are graded between basic (D, C ratings) and best practices (B, A ratings), but the majority could be characterized as describing basic traditional budget control processes (even with an A rating). However, even if agreeing on the use of PEFA, there is disagreement between experts on required indicator ratings to reach "basic" standards. Another disadvantage as an aid to sequencing decisions is that the PEFA framework does not prioritize between its indicators, even though some are derivative (or what Tommasi calls "resulting indicators").[26] However, perhaps the problem lies deeper than PEFA's limitations. Underlying the failure to agree a universal order for sequencing reforms is a generally held opinion that this would in any case be undesirable. This opinion is founded on two consistent and interrelated themes that emerge in the literature reviewed: first, reform design should be country specific, and there are dangers in generalizing across countries; secondly, successful reform design involves more than technical aspects of PFM, and other external factors are often critical to success.

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[25] Although, to be fair, he does offer a basic checklist of first priority PFM objectives: protect public money; complete budget coverage; offer a multi-year perspective; improve public investment preparation and programming; and provide some attention to results. (Schiavo-Campo, 2010, p.12).

[26] It has been noted that Quist attempts some prioritization, dividing countries into Level 1, (basic traditional budgeting) and level 2 (policy-based budgeting); and Andrews identifies empirically priorities for lower level African countries to progress their PEFA scores to those of higher level ones.

20. **There seems a general consensus that there can be no universal reform sequence, since reforms should be geared to specific country circumstances.** This conclusion could be interpreted as nullifying any attempt at generalization about sequencing.[27] However, if one examines the literature, especially that dealing with country case studies, it is not difficult to discern some agreement on what should come first. The agreement is admittedly incomplete, as the previous discussion on what constitutes "basics" makes clear. None the less, the first steps in sequencing reforms in many different countries in different parts of the world are not so widely different as one might at first expect. Previously it was noted that Schick's view of the first steps in sequencing should be directed to what he would call fiscal discipline. An examination of the content of the first platforms in reform programs most usually quoted, that of Kenya and Cambodia, reveals these first platforms generally also contain reform activities directed to those areas that Schick would most probably recognize as falling into his "basics first" category. Similarly, the "evolutionary approach" favored in Ethiopia, contains as its first stage the establishment of basic traditional budget controls, not out of line with Schick's view of basics.[28] So while in the sequencing literature there is much debate on the order of reform action, when it comes to reforms in practice the differences do not appear so great. This suggests one should not stress too much the uniqueness of countries as undermining the idea of some logical order in sequencing reform. What is evident is that although their first platforms usually contain activities aimed at establishing "basic" PFM processes, countries differ in where they give priority, favoring some basic PFM processes over others. The literature suggests these different priorities perhaps can best be explained by non PFM factors.

21. **Almost all experts in the field stress non-technical factors as heavily influencing the design and the success of reform initiatives in the PFM field.** Unfortunately, while there is general agreement on the importance of non-PFM factors, there is no consensus on what they are, except perhaps again that they vary between countries in importance. The scope of the factors identified in the literature is very wide. Allen (2008), complains that PFM reform advice is often poor because advisors are unable to see beyond budgetary institutions and PFM systems. He argues that it is important to recognize that "reforming institutions is a necessary but insufficient condition for improvement; other important considerations are people, skills, organization, and information" (Allen, 2009, p.23). This echoes the arguments advanced by Schiavo-Campo and McFerson, 2008. Brooke, in advancing the platform approach, highlighted the importance of the political context, as well as four other important factors: capacity development; motivational development; process

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[27] Note Schiavo-Campo's warning that "we must recognize that any prioritization must be country-specific and reality based", and that "attempts at identifying a universal sequence of actions are not only unrealistic, but also undesirable as they carry the twin assumptions that the sequence is both linear and unidirectional", Schiavo-Campo, 2010,p 4.

[28] The sequence starts with building a "transactions platform" (budget system, accounting, disbursement systems and their supporting systems) to ensure efficient financial control.(Peterson, 2007).

development; and institutional development.[29] For Tommasi the country context includes, "among other elements, human resources capacity, current strengths and weaknesses of the budget system, the administrative culture and the institutional and political context." (2009, p.10). This agrees with Quist, (2009, p 7), who sees "the political context, the maturity and level of activity by civil society, the level of donor harmonization, the degree of ownership of reform strategy along with the political will, all factor into the sequencing of reforms"[30] As noted in the African context Andrews empirically associates a number of external factors (growth, stability, revenue structure, length of reform commitment, colonial heritage) with higher PEFA ratings. Given this common position, it is difficult to avoid the conclusion that in reform design one may have to accept non-technical factors will trump purely PFM technical factors in determining priorities and the sequence of reform actions, both the order in which they are undertaken and the timing required for their completion.[31]

22. **There appears a general acceptance of the view that success and failure in PFM reform should be judged by the outcome of reform action in achieving PFM objectives.** In the design of reform programs, nearly all experts stress the importance of setting milestones of success by indicators of outcomes to be expected by PFM reforms. This focuses on the "deliverables" of the PFM system. Usually care is taken to specify what is to be the expected outcome of meeting "basic" PFM processes, or the expected outcome of achieving platform targets. This appears to be a common role assigned by most experts to the PEFA process--an assessment tool founded on a framework defining the desired outputs/outcomes of a well functioning PFM system. It is also recognized in the literature that not all desired PFM outcomes are relevant for different countries at different stages of the development of their PFM systems. Most contributors recognize that at different stages of development, countries operate what are essentially different types of budget system: moving from a traditional budget environment concerned with the control of inputs to "policy based budgeting" more concerned with outputs and outcomes. Thus Schick matches his "basic" PFM functions to different types of control required by a system that centralizes budget management, concentrates on inputs (individual items of expenditure) and is more concerned with compliance with line budgets, and civil service rules and financial regulations. For

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[29] **Capacity development** denotes that people, institutions and societies are enabled to perform functions, solve problems, set and achieve objectives. **Motivational development** considers how people can be carried through changes. **Process development** addresses the aspect of organizational structure and how organizational change can occur. **Institutional development** looks at aspects such as laws or policies, and also deals with institutional culture that regulates behavior. It should be noted that Bergmann and Bietenharder when they surveyed experts in the field of public sector accounting reforms found that there was a general acceptance that these "soft factors" were central for sustainable PFM reforms (Bergmann and Bietenharder, 2010, p.6).

[30] Moreover, he would also add, "internal political factors pertaining to appropriate incentives for the professional cadres responsible for undertaking the PFM reform activities that must be considered. These too are always complex and require a subtle appreciate on the roles, inter-relationships and power levels of the reform leadership." P. 7

[31] This Dorotinsky would argue is necessary, since reforms need to be feasible in the given political context, and it is important that they be defined by the "patient"—what is the most desired treatment that this required—determined, he suggests, by what is the weakest link in the PFM subsystem (Dorotinsky, 2010).

Tommasi the basic PFM system focuses on fiscal discipline ensured by control over fiscal aggregates, emphasis on due process, compliance and probity, with basic legislative scrutiny and accountability and hopefully with an adequate degree of transparency (Tommasi, 2009, p.22). As noted, Quist divides countries into two levels, where the first level operates a traditional budget system that would not be markedly inconsistent with that described by Tommasi.[32]

B. Chapter II: A Framework for Interpreting the Sequencing Literature

Summary: *This chapter revisits the meaning of sequencing, and suggests an analytical framework based on two main principles. First, that two fundamental dimensions of sequencing should be considered together: the order of reform actions and their timing. It is argued the order of reform actions can follow an historical perspective but timing, or the pace of reforms, will depend more on non-technical country specific conditions. Secondly, regarding the order of reform activities a hierarchy in sequencing decisions is proposed: the higher level priorities should be agreed before going on to the lower order, more technical, aspects of sequencing individual reform actions. Using this framework the literature on PFM sequencing is reinterpreted. This identifies some areas requiring further clarification, and indicates how they will be addressed in this Background Paper.*

A Suggested Framework for Reviewing the Sequencing Literature

23. **There is the need to impose some structure on this wide ranging literature.** In attempting to distill guidelines from this seemingly disparate and wide ranging literature, it was felt necessary to offer a conceptual framework in which to fit the various arguments encountered. This framework rests on two main premises. First, sequencing reform involves more than just deciding the technical order in which reform activities should take place. Second, sequencing reform activities cannot be divorced from the ultimate objectives of reform, so without some agreement on the latter it is difficult to agree on the former. An attempt will be made in this section to reinterpret the literature within this conceptual framework. It is hoped that in this way to stress the surprising degree of consensus to be found in the literature, as well as highlighting the main areas of discord, and pointing to further issues that should be addressed.

24. **The definition of sequencing should recognize two dimensions.** It is suggested that as a first step it may be useful to revisit how "sequencing" has been interpreted in the literature. While there are special interpretations of this concept in science, music, and mathematics, a most general definition found in the dictionary for "sequence" is as a chain of events. So when talking of sequencing PFM reform it would appear we are trying to define a

[32] "The first platform (or series of platforms), consistent with the achievement of fiscal discipline, will therefore include such reform activities so as to address budget comprehensiveness; predictability of revenue receipts, budget releases, procurement and expenditure steps; control - with input controls being addressed prior to output controls; transparency; accountability; and the frequency, timeliness and accuracy of reconciliation procedures, financial reporting and accounting; and finally external audit and oversight." Quist, 2010, p.18.

chain of PFM reform actions. Within that definition it is also possible to identify two associated dimensions: the ***order*** in which actions are taken and the ***timing*** of the actions. Indeed, the sequencing literature is peppered with references on the need to be realistic about the time taken to complete reform activities, and factors that may affect this timing. This is often reflected in discussion of the "pace" of reform (see Schiavo-Campo and Tommasi, 1998).[33] For example, Browne also emphasizes pace, stressing that " phased implementation" of any sequenced action is important " in ensuring that reforms will fit the absorptive capacity of the system and not cause reform fatigue" (Browne,2010, p. 12). She recommends that in the design of a sequenced reform there should be periodic digestion and consolidation periods built in to ensure changes are internalized. When discussing the pace of reform DFID sees this as heavily influenced by whether reforms are driven by crisis, as well as if they are internally and externally driven (DFID, 2001, section 9.1). In the literature it is also possible identify arguments that the time taken to implement reform activities should influence the order in which they are undertaken, for example, in emphasizing the need to consider roll-out effort in sequencing priorities also suggests reform actions that will have priority (Quist, 2010). It will be argued that these two dimensions—order and timing—should be accommodated in any attempt to sequence PFM reforms, and that decisions on both dimensions will need to be consistent to assure success. Previous discussion on reform sequencing often has failed to explicitly differentiate these two dimensions, and has perhaps tended to concentrate more on the order of reform actions.

25. **The *ordering* of reform actions should be thought of as a two-stage process.** First, at a higher level of decision making, it consists of getting the overall reform priorities correctly ordered. These reform priorities should be decided by what the PFM system is designed to deliver (or what is the outcome to be achieved by the PFM system as a whole?). Secondly, once the high level reform priority is decided, at a lower more technical level of decision making, sequence consists of ordering reform actions to achieve this priority or deliverable. It is at this lower level that detailed sequencing of reform activities is most justified. It will also be argued that if the higher level prioritization is wrong, then sequencing reform actions at the lower level is unlikely to be successful.

26. **The second dimension, the *timing* (or pace) of reform actions is often acknowledged as critical to successful reforms.** Getting the timing wrong, both of when to commence and how long to allow for a reform action, will undermine any successful sequencing of reform. Further, it should be recognized that the timing of reform actions often depends critically on non-technical factors that are external to the PFM system, and as such will inevitably be country specific. This has two implications. First, while it may be possible to generalize across countries about the desirable order in which PFM reforms should be undertaken, since timing will be country specific, it is not likely to be possible to generalize

[33] They stress that "strategic attention should focus on identifying areas where it is feasible to move very fast, and areas where it is essential to build slowly and carefully the solid institutional foundation required for sustainable reform" (Schiavo-Campo and Tommasi, 1998, p.109)

across countries about reform sequencing overall. Second, sequencing cannot be considered solely a PFM technical matter outside each country's political economy of reform. It is difficult to avoid the conclusion, therefore, that to come to implementable decisions on sequencing requires these external non-technical issues be addressed directly.

27. **A hierarchical approach to sequencing is proposed.** Exploring a two stage approach to ordering reform actions, there seems some broad international agreement about what the ***top level priorities*** of a PFM system should be. This agreement is based on what the PFM system is designed to deliver. There are many variants on the theme, but it is argued here that in an "ideal" PFM system there are at least three main "deliverables". First, there should be a basic level of ***financial compliance or fiscal control*** enforced by the system. Second, there should be processes in place to ***ensure aggregate fiscal discipline***, in the sense that the PFM system can support macroeconomic stability in the economy over the business cycle, as well as ensure longer-run macro fiscal sustainability. Third, given the previous two deliverables, the PFM system should enable managers to ***attain agreed sector policy priorities in an efficient and effective way***.

28. **It is evident that the view of the scope of PFM adopted in this paper, and in particular the identification of its deliverables, is at variance with some other accepted interpretations.** Specifically, over the years a particular perspective on the objectives of PFM has emerged and become part of the landscape, often used but not much questioned. This perspective focuses on the threefold pillars of a good budget system that was introduced in the 1999 World Bank PEM Handbook, namely: aggregate fiscal discipline, strategic allocation of resources, and efficiency in resource use. While not denying the threefold classification has its uses, it can be argued that it is far from sufficient in discussing the deliverables of a PFM system or for modeling PFM reform. The main deficiencies are twofold: it emphasizes policy objectives not management objectives; and is too narrow in scope, concentrating on budgeting but not the whole PFM system.

29. **It can be agreed that the budget formulation process should focus on resource allocation decisions determining government policy at three levels**, namely:

- *Top level decisions* determine how resources are to be allocated between the government and private sector, revolving around the desired size of government. This determines the overall resource envelop available to the budget. If functioning properly this aggregate use of resources by the government sector will be compatible with overall macroeconomic balance in the economy and any resulting debt levels will be sustainable over the longer-term.
- *Middle level decisions* determine how this overall envelop is to be divided between the different sectors/ministries to meet policy priorities. If functioning properly the budget process will ensure that resources are moved to high priority areas away from low priority sectors and programs.

- *Lower level decisions* determine how resources will be divided within the sector/ministry envelop to best meet policy objectives. If functioning properly, resource allocation decisions at this level will be made so that policy objectives are reached in the most efficient and effective way.

30. **All these resource decisions are usually reflected in the budget document, which represents perhaps a government's most important policy document.** However, some qualifications are in order. It should be noted that often the budget is an incomplete policy document since government policy can be pursued by other means: extra-budgetary funds, quasi fiscal operations, regulations, etc., all such activities should be included from a public financial ***management*** perspective. Moreover, few countries actually display such a pristine strategic budget process envisaged above. The three levels of decision making tend to be taken together not separately. Bottom-up demands often determine overall government size; how sector envelopes are decided often determine how ministries allocate their resources, etc. Seldom in practice is the budget formulation process broken down into these neat three strategic decision levels, but they are intertwined in some negotiated end result that is politically acceptable.

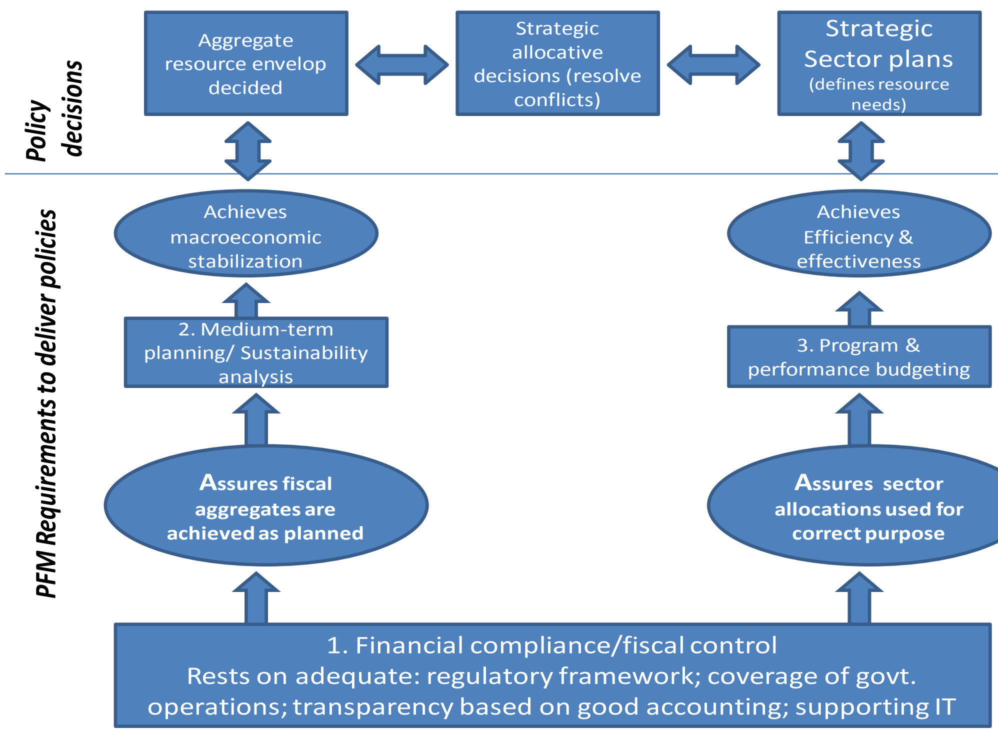
31. **However, the most important qualification to adopting this approach to modeling PFM reform is that budgeting (preparation, presentation, approval) is only one component of PFM.** The PFM system represents all the regulations and procedures that ensure that the threefold policy decisions previously described are fully complied with. That is, apart from ensuring the budget preparation process is effectively functioning as described previously, there must be in place a system to execute the budget that ensures resource allocation decisions are complied with, monitored and reported, and treasury operations that ensure this execution takes place smoothly in terms of cash availability, and is financed efficiently through debt management operations. Adopting this wider perspective it is possible to identify the three main management objectives or "deliverables" of a PFM system used in this background paper:

- **First, the system should enforce basic financial compliance.** Without this basic feature it is impossible to deliver government spending in line with resource allocation decisions at all three levels that have been politically agreed, and so use the budget as a tool of government policy.
- **Second, there should be processes in place to ensure aggregate fiscal discipline, in the sense that the PFM system can anticipate and adopt any changes required to fiscal aggregates to counter macroeconomic imbalances and help ensure overall stability in the economy.** This requires budget planning to ensure macroeconomic stability not only from the perspective of the current fiscal year but over the business cycle, and even for longer periods to ensure this stability can be sustained. From the policy viewpoint, basic macro fiscal stability is often considered a precondition and safeguard to successfully delivering other government policies reflected in budget allocation decisions.

- **Third, given the previous two deliverables, the PFM system should put in place procedures to be able to attain agreed sector policy priorities in an efficient and effective way.** This usually requires the adoption of a program oriented approach to the budget, focusing on the outputs rather than the inputs of the budget system, and the use of performance information and processes to enhance program managers' delivery of desired policy objectives.

32. **From this is derived an overall picture of a more advanced PFM system shown in Figure 2.1, describing the management processes required to deliver strategic policy decisions at all three levels**. The three fold deliverables of this system underlie many of the currently used internationally accepted tools, such as PEFA, used to assess how successfully a country's PFM system functions. Indeed it should be noted that the majority of PEFA indicators measure the degree of financial compliance, an objective completely ignored in the conventional threefold policy-oriented classification of objectives.

Figure 2.1 Schematic Overview of the PFM Conceptual Framework based on Three Main Deliverables



The Hierarchy among Top Level PFM Priorities

33. **The historical record of how PFM systems have actually developed also suggests a hierarchy among these top level deliverables.** If we examine how the advanced PFM countries developed their PFM systems, we find, (accepting particular country idiosyncrasies

mentioned by Allen),[34] a similar progression as that described above. First, countries pursued *financial compliance*, in this way to ensure control over revenues and expenditures so that they are consistent with annual budget appropriations and are undertaken in accordance with budget legislation usually buttressed by detailed financial regulations. Generally such PFM systems focused on detailed line-item budgeting with the emphasis on ensuring the most economical use of inputs. For this basic control to be effective requires the budget to be as comprehensive as possible to include all government spending, with centralized controls in a strong finance ministry, the operation of centralized cash management (a treasury single account), a regular budget calendar, timely (usually cash) accounting, regular reports, strong internal controls, and an active external audit function reporting to the legislature.

34. **Once this basis of financial discipline was achieved, historically with the rising importance of government activity in the economy and with the spread of Keynesian ideas, more emphasis was placed on controlling fiscal aggregates over time.** PFM systems were developed so that fiscal aggregates could be adjusted to attain aggregate fiscal discipline so as to *ensure macroeconomic stability and sustainability*. It was realized that both objectives involved fiscal planning over the business cycle. This led of necessity to a break from rigid annual budget planning, and to embrace a medium term perspective in fiscal planning. In terms of PFM processes this was associated with the development of improved macroeconomic and fiscal forecasting, timely reports on fiscal aggregates, medium term fiscal and budget frameworks, and debt sustainability analysis. For developing countries, it has also encouraged better investment planning, taking account of future recurrent cost implications of present capital spending, and in better programming and managing of aid flows.

35. **Latterly, more especially in OECD countries, PFM systems have been adapted to ensure better policy delivery, with an emphasis on outputs and outcomes of publicly provided services.** This *emphasis on efficiency and effectiveness* in service delivery has resulted in PFM emphasizing strategic planning, program budgeting, use of performance indicators to monitor and evaluate, and more decentralized management systems, typically associated with a move from cash to accrual basis accounting (see Chapter IV).

36. **This progression involved a change in emphasis and a widening of PFM objectives, not replacing one with another.** While countries have varied greatly in the universality in which they adopted these three main PFM functions, (and even within OECD countries the process continues), the history of reform in this area generally shows a widening of PFM objectives in the direction previously described. It also shows that at each stage of developing their PFM systems the new objective, or deliverable, was added and did not replace other deliverables. That is, the later emphasis on value for money and policy delivery still rested on financial compliance and aggregate fiscal discipline. This view of

[34] It should be noted that Dorotinsky agrees with Allen on the idiosyncratic development of PFM systems. Namely for him PFM systems "were developed gradually, incrementally, addressing one weakness at a time, always responding to the needs of policy makers" (Dorotinsky, 2010).

reform priorities based on this historical perspective is illustrated schematically in Figure 2.2. The pyramidal form stresses that the deliverables should be regarded interdependent: financial compliance supports the other deliverables, both macro stabilization and efficiency and effectiveness; and in turn macro stabilization supports efficiency and effectiveness and eases the task of ensuring financial compliance. From the PFM management perspective, these stages represent the development of different skills and processes: those required for traditional compliance oriented annual budgeting will have to be supplemented by further skills to deliver multi-year macro-stabilization and sustainability objectives; and these in turn will have to be supplemented by other skills and processes to deliver increased efficiency and effectiveness in service delivery.

Figure 2.2 Reform Priorities

Primary Objective/deliverable *Type of budget system*

Traditional input control,
with multi-year orientation
Emphasis on macro policy
Centralized management style

37. **Historical precedence should be used as a guide in sequencing at the highest level.** If one accepts this broad view of PFM development, one must ask why reinvent the sequence of budget reform? Would it not be safer to adopt the sequence suggested by historical precedence: first, create a PFM system that delivers financial compliance/ fiscal discipline; second, once achieved, develop the PFM skills and processes so as to be able to determine and adjust fiscal aggregates to ensure macroeconomic stability/sustainability; third, once this is achieved move to getting better value for the money spent in terms of better achieving sector policy objectives and attaining more efficiency in delivering services. These three stages in PFM development, it is suggested, should guide the ordering of higher level priorities in shaping the sequencing of PFM reforms. At a lower more technical level, within whichever of these three broad PFM deliverables is chosen as most relevant, reform actions to attain and strengthen this PFM priority could then be sequenced, again taking due account of factors specific to each country.

38. **Within this top-level sequence there is greater scope for tailoring sequencing to country specifics.** For example, if once basic financial compliance is assured and it is decided to move to achieve greater macroeconomic stability through, say, the adoption of a medium term budget framework (MTBF), then this would be introduced in a sequenced way (as indicated in Chapter IV. The sequenced reform actions required, and their timing, would accommodate the different stages of the budget cycle, the need to build up technical capacity to undertake this work, and a realistic phased introduction within the budget system, not just the central institutions. It may also require additional legislation and certainly a changed budget calendar. Similarly, if it was felt financial compliance was robust, and that the finance ministry had developed the capacity to adjust fiscal aggregates if required, it might be considered useful to move to the third, higher level, PFM objectives. For example, to try and improve efficiency in government spending it might be considered useful to move the budget classification structure away from its typical economic and administrative basis to a program basis, where programs reflect government sector policy objectives. This should be introduced in a sequenced way, with reform actions designed to introduce in stages, ministry by ministry, meaningful programs based on their strategic plans (as discussed in Chapter VI X). Ultimately, the style of management would require to be changed, away from centralized controls to a more devolved PFM regime where line managers were given space to manage. Again, the timing of introducing the reform actions would take into account the special circumstances of the country, the results that policy makers wished to be derived from this reform, and its pace would be based on the time required to build the necessary skills and change processes.

39. **There are inherent dangers in attempting to "leapfrog" in this top-level sequencing.** In accepting the logic behind this hierarchical approach, it would not be advisable to move to detailed sequencing of reform actions that conflict with the country's top level priorities. For example, it does not make sense to begin developing a MTBF when there is insufficient basic financial compliance to enable a country to successfully execute an annual budget. Similarly, introducing program budgeting when one cannot ensure financial compliance, or overall stability in aggregate resource envelopes, does not make sense and could prove counterproductive. *To sum up, it is not likely to be possible to get reform sequencing right if the overall reform priorities are wrong.*

Using the Framework to Re-Interpret the Sequencing Literature

40. **The conceptual framework used in the Background Paper is based on a sequencing compatible with historical precedence.** Using this conceptual framework—of a hierarchy in sequencing based on an historical perspective, and recognizing sequencing involves both the order and the timing of reform actions—it is instructive to revisit the sequencing literature. Most obviously the above framework adopts the historical approach that has been employed by several contributors to the literature, but does not come to quite so negative conclusions as some of them have. Despite recognizing the wide country variations in reform trajectories and time lines, there is an end-result to PFM reform that is usually identifiable and shared among countries. It only needs to be recognized at what stage of PFM

development each country has reached. It should be conceded that not all contributors in the field are convinced that the historical perspective of PFM reforms in advanced countries is totally relevant for developing countries.[35] What is more relevant, it is argued, is to have reforms that are politically supported and are implementable. However, it will be argued later in this paper that taking this position too far has some inherent dangers.

41. **The conceptual framework of the Background Paper is also compatible with the "return to basics" approach.** The hierarchical framework advanced previously has an obvious kinship with the "return to basics approach" associated with Allan Schick. The argument presented here, that a first priority or deliverable of a PFM system should be financial compliance so the agreed budget is the one delivered, could be interpreted as fulfilling the "core PFM functions" compatible with Schick's view of what the "basics" consist of. One other important area of agreement is to recognize that Schick's was a plea to get basic PFM functionality right before moving on to more sophisticated PFM reforms. This mirrors the argument here that PFM reform should be built on a solid base of financial compliance before moving to fulfill other PFM objectives, stressing that the order in which these priorities are addressed is important to reform success.

42. **The conceptual framework is not incompatible with the platform approach**. If "platforms" are interpreted as fulfilling each of the three stages of PFM development described previously, and the package of reform actions in each platform is directed to attain each stage with little overlap, then the approach is exactly consistent with the conceptual framework presented here. One could then agree there were three main platforms to be defined, that would be similar for each country, while not ruling out sequenced actions (or sub-platforms) to attain the principle platform PFM objectives. Thus the reform package directed to attaining each platform, and their time lines, would differ with each country's particular circumstances and the external factors it faces, but the overall reform trajectory would be the same. Indeed it should be stressed that the proposed conceptual framework agrees with two important aspects that characterize the platform approach to PFM reform. First, it is agreed that the country specific nature of the reform process determines the "mix" of reform actions to be undertaken, and the timing of their introduction and speed of completion (i.e., pace of reforms). Second, as in the framework suggested in this paper, platforms have been defined on clearly identified outcomes to be derived from PFM reforms.

43. **But the alignment of the framework with the platform approach is not perfect.** The greatest potential source of disagreement with the platform approach is in the "mixing" of the hierarchy of reforms: attempting reform actions designed for the first platform, defined here as "financial compliance", combined with reform actions designed for subsequent

[35] For example, Andrews argues that "Instead of focusing incessantly on achieving external legitimacy, governments should attend to where their PFM systems need strengthening for better service delivery, macroeconomic stabilization, allocation, and such, and pursue reforms relevant to the domestic problem" (Andrews, 2010, p.65). This is not too out of line with the DFID emphasis on being "opportunistic" in pursuing reforms.

platforms such as introducing medium term fiscal planning (e.g., MTBFs) or performance objectives (e.g., program budgeting). As indicated previously, this paper sees some danger in pursuing other PFM objectives before sound financial compliance, at least up to some “core” level, is in place. Some case studies where this has occurred are illustrative. For example, Pessoa in describing the stages in the evolution of PFM reform in Brazil, noted the first phase concentrated on core systems such as budget execution, cash and debt management, but in the second phase performance budgeting was promoted, ahead of the third stage internal controls and internal audit, and the fourth stage, fiscal rules and fiscal reporting. He notes that performance budgeting has been the weakest part of the reform effort, and judges this was initiated prematurely, without adequate preconditions (Pessoa, 2010). Kuteesa, in describing the stages of PFM reform in Uganda, noted the first stage focused on enhanced fiscal discipline directed at core functions, but this was followed by a second stage where “results focused budgeting” was introduced, and then rapidly thereafter stage three introduced output based budgeting and performance contracts (Kuteesa, 2010).[36] While many of these innovations were donor inspired and financially supported, there are many doubts over the wisdom of the detailed cumbersome reporting and monitoring required to operate this results-based budget system in a centralized way (see comments by Schiavo-Campo, 2010). The case of Jamaica is another case in point. Urged by donors, over the years Jamaica decentralized its PFM, allowing “managers to manage” with considerable freedom to encourage performance budgeting reforms. While reaching for third level reforms, the country exhibited poor financial compliance and macro fiscal discipline, and the debt to GDP ratio rose to record breaking levels.[37] Recently, in discussions with the IMF, there has been some recognition of the need to reverse the decentralized management style, to improve centralized cash management and controls, and restore fiscal discipline—a return to the “core functions”.

Areas Addressed in this Background Paper

44. **This attempt to impose a common conceptual framework on the sequencing literature reveals not only areas of agreement, but also the gaps and areas where it is difficult to find consensus.** Having greater clarity on these issues will facilitate coming to commonly agreed guidelines on reform sequencing. These areas are discussed in the subsequent two parts of the Background Paper as follows:

Section I describes in detail sequencing based on the typical reform path of PFM systems and addresses the following issues:

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[36] Note also the reference in DFID, 2001, Box 9.4 p. 47, that describes Uganda getting the basics right, at the same time as recognizing the results-based elements.

[37] It should be noted that in an appendix Quist applies his Sequence Model Framework to the PEFA scores prior to the reversal in reform strategy with predictably misleading results. The fact is the original PEFA assessment did not pick up the fundamental flaw of the Jamaica PFM system, the inconsistency of a decentralized management system when fiscal discipline required a centralized approach.

45. **The need to specify technical requirements to reach core and subsequent PFM levels.** Any justifiable sequence of reform actions will require clear indicators of PFM achievement in terms of the deliverables of the system. Specifically, to make the concept of "core PFM functions" operational, and agree the expected PFM deliverables beyond this core level, requires careful identification of the PFM functions involved, and the suitable standards at which they should function. To accomplish this it is proposed to use the widely accepted PEFA system of indicators, as discussed in Chapter III, and defined in detail in the second background paper (Tommasi, 2012).

46. **The need to provide a solid basis before moving to more advanced reforms**. Even if "core" PFM functions are in place, it is necessary to recognize that there may be desirable preconditions that need to be met before moving to reforms "beyond the core". Before moving to more advanced reforms, investing in a solid PFM "infrastructure" will be required. For example, the IT requirements, the accounting system, PFM's legal and regulatory base, are all likely to require strengthening or modification to support reforms to progress the PFM system beyond the core level. The implications for these supporting functions of moving beyond the core is discussed in Chapter IV.

47. **The need to describe the sequencing of more advanced reforms based on historical precedent.** When moving to advanced reforms beyond the core, important sequencing decisions are still faced and must be resolved. These more advanced PFM areas have not received as much attention in the sequencing literature, but often these reforms have proved difficult and time consuming to implement. Sequencing reform actions "beyond the core" is just as critical as "within the core". The approach to sequencing such reforms as medium term budget planning, and program and performance budgeting, is discussed in Chapters V and VI.

Section III examines how sequencing decisions should be made in specific country environments, and addresses the following issues:

48. **Decisions on sequencing need to be placed into the wider context of decision-making process regarding PFM reforms.** It seems clear from the literature that questions on sequencing cannot be answered on purely technical PFM grounds. Indeed, some argue that it would be dangerous to do so. Consequently, it is argued, sequencing cannot be divorced from broader issues of reform design, rather it is a component of a wider reform decision process. Recognizing this is to recognize that any decisions on sequence are likely to be heavily influenced by the specific country characteristics of this wider process. For example, one dimension of this problem is the need to relate sequencing to other on-going reforms within and parallel to the PFM area. How this wider context impacts sequencing decisions is discussed in Chapter VII.

49. **Decisions on sequencing cannot avoid addressing how to accommodate the influence of nontechnical factors, arising from the wider political economy of the**

country. One of the most critical components of the reform decision making process is the influence of non PFM external factors. If it is to be successful the planned reform action must come to terms with the reality of the political economy of each specific country, as well as the institutional arrangements of PFM, and even the individual characteristics of the organizations in which the reform is to be introduced. It is important to reach some consensus on how to analyze these influences, how to modify reform actions to accommodate them, or when to take action to remove constraints that they may impose on successful reform. An analytical approach to these non PFM external factors is discussed in Chapters VIII and IX.

50. **However well technically specified, and however enabling the environment, reforms require to be "engineered", stressing the important role of change managers.** Even if judged viable in terms of the wider decision-making process and prevailing political economy environment, the success of reform delivery will depend on the amount of investment that is made in managing the reform process. This requires "engineering" the PFM reforms to fit the specific country environment that in turn stresses the importance of change management in ensuring reform success. Chapter IX offers a framework in which to analyze and incorporate this important dimension in reform sequencing decisions.

51. **How to resolve the typical prioritization problems faced where PFM systems are weak and fail to reach core levels over a wide range of PFM functions.** In such cases the general prescription of first reaching core levels does not suffice as a guide to action, but rather choices must be made between reform actions supporting different core functions. How to prioritize reform actions is examined in Chapter X, where a risk-based solution to this problem is advanced that also has more general application for sequencing beyond the core PFM level.

II. An Overview of Sequence in the Development of a PFM System

A. Chapter III: Step One: Establishing "Core" PFM Functions as the First Reform Priority

Summary: *It is proposed to re-interpret the "basics" as core PFM functions, and use the PEFA indicators to measure the attainment of core level of functionality. While leaning heavily on the PEFA analytical framework, important constraints are recognized in using this framework for prioritizing reform activities, namely: PEFA may not technically cover all the desirable attributes of "core" PFM functions; many LICs are likely to reveal many weaknesses in their core scores, but PEFA does not allow prioritization between them; finally, despite common agreement on their importance in sequencing reforms, PEFA cannot handle external non PFM technical factors.*

The Need to Move Away From "Basics" as a Reform Target

52. **The concept of "basics" is unclear both with regard to the PFM functions to be included as "basic" and the levels at which those functions should operate.** As discussed previously, there are many points of contention that have been generated by the "basics first"

approach to sequencing. Undoubtedly, there is a fundamental conundrum that must be addressed: if so seemingly simple in approach, why does the "basics first" model find it so difficult to gain acceptance? One answer, as indicated previously, is the technical ambiguity regarding what is: "basic". Consequently, it is unlikely that for any country experts would agree on what the "basic" level of PFM should consist of. A further complication is that "basics" are likely to be interpreted differently for different types of country e.g., developing, post conflict, or former planned economies (or even between countries operating Anglophone as opposed to Francophone budget systems).

53. **The concept as a reform objective is not particularly "marketable".** A second reason for its lack of acceptance as a reform strategy is that the "basics first" approach has obvious problems in capturing political support. The concept lacks "marketability" to reform minded administrations: what if these countries want more? It is difficult to "sell" basics when reformers know there is something more advanced that exists in other countries that other reforming countries are pursuing. This may just be a problem in the label, but it can be questioned whether, even if technically better defined, the concept of "basics first" can really be repackaged to be more politically acceptable. Another complication often faced in making the concept more politically attractive is that many countries have previously attempted PFM reforms and, because of this, they inherit a legacy of reform activities where there may be substantial political investment. This often leads to a trickier political problem: what to do with on-going reforms that may over-reach what is considered as the basics? Some have suggested donors should be bold enough to actively dissuade countries pursuing such "unsuitable" reforms, others that these reforms should be accommodated in the reform program, (perhaps on a separate parallel track),[38] still others say that if countries show commitment to the reforms they should be supported, regardless of PFM basic priorities (see, for example, Andrews, 2010).[39] Definitely, given the widespread nature of the problem this is an area in the literature that would benefit from further, preferably empirically informed, discussion, that is presently lacking.

54. **Pursuing "the basics" may have some longer-run drawbacks.** Even if all the above questions could be answered, there appears to be a theoretical reason, (hinted at rather than explicitly stated), why some PFM experts could be uncomfortable with the "basics first" approach. The "basic" traditional budget model is one of central control, of detailed line item management, usually through a powerful finance ministry, with the line ministries often relegated to financial administrators rather than true managers of their budgets. The "basics first" approach would aim to strengthen this budget model, which raises the issue: is it

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[38] For example, Tommasi goes so far as to advocate that "in some poor countries the main issue is fixing reforms badly designed, not sequencing" (Tommasi, 2010). Although this does beg questions as to the value fixing reforms judged irrelevant, or too ambitious, or donor-inspired, or even if "fixing" could include dropping them.

[39] He argues for reforms that are less similar and more context appropriate. His hypothesis is that the budget reforms that have the support of the top management are the ones that succeed, regardless of whether they are "basic" or "advanced" (Andrews, 2010, p. 63).

possible to get trapped in the basic model and find it difficult to escape to more advanced PFM functionality that typically requires loosening this central control? While improving centralized compliance controls undoubtedly does initially assist efficient resource use, at least up to some point, eventually diminishing returns set in and overly centralized controls have a price in diminished efficiency. This is, after all, the prime reason why advanced countries chose to move away from this management model. A centralized management approach is probably well suited to pursue basic financial compliance and macroeconomic stabilization objectives. But to pursue efficiency and effectiveness in service delivery a more decentralized management style is likely to be required. As a consequence, emphasizing different higher level PFM objectives will imply changing the entire budget system—how the budget is prepared and how it is executed.[40] Recognizing that different top level PFM objectives are best pursued by different management models warns of the dangers in mixing reform actions aimed at different objectives, and stresses the importance of a logical sequence in reforms. It will be remembered that this was the reason for the warning that unless the top level priorities are properly aligned with the lower level sequencing of reform actions, the latter are unlikely to be successful.

55. **To avoid many of the past controversies associated with the "basics" concept, it is proposed in this paper to replace it with the concept of *core PFM functions*.** To make this concept operational meaning, these core functions will be identified in sufficient detail that will allow them to be measured, for the most part, by the use of PEFA indicators. Further, the level of scoring on those indicators will be explicitly identified that would signify a core level of PFM functionality. It is then proposed that attaining this level of core functionality should be the first priority in PFM reform.

Defining What Constitute "Core" PFM Processes

56. **In establishing core functions as a reform target the first priority is to reach agreement on what a "core" PFM system should deliver.** Such a system, it has been argued should be focused on the first PFM priority—financial compliance. The latter is strictly interpreted as adherence to the all the legislation, regulations and procedures governing public sector finances. The underlying objective is to ensure overall fiscal discipline or control over the use of public resources. In this Background Paper it will also include some supporting requirements that will make financial compliance easier to attain, such as the establishment of a realistic (or credible) budget.

57. **The first step in adopting core PFM functions as a reform objective is to define these functions.** Box 3.1 proposes the PFM functions what could be included in this concept of financial compliance. Of course, given the controversy and wide range of interpretations of what constitute "the basics" it is should be recognized that it will be equally problematic to define core functions. Rather Box 3.1 represents an attempt to summarize, as much as is feasibly possible, an agreed list of "core" PFM processes encountered in the literature that are

[40] Managing this change process, and its PFM implications, is further elaborated in Diamond, 2006.

directed to ensure "financial compliance" or "fiscal discipline". Fortunately, it is not difficult to see how these functions can be matched with the dimensions measured by the PEFA framework.

Box 3.1. Some Key PFM Functions Required to Ensure a "Core" Level of Financial Compliance

- ***Realistic budget***
  - Revenue forecasts are realistic, based on detailed analysis of tax bases
  - Expenditures are fully costed, with adequate allowance for inflation, exchange rate movements, recurrent costs of completed investments

  OUTCOME: Budget outturn is close to budget approved ex ante

- ***In-year control over spending***
  - Commitments are controlled as well as cash
  - Budget is comprehensive, and makes adequate provision for contingencies

  OUTCOME: Budget outturn avoids overruns and arrears

- ***In-year control over revenues***
  - Tax administration has capacity to enforce tax laws
  - Continual analysis and follow-up of revenue collections versus estimates

  OUTCOME: Budget revenue outturn avoids shortfalls and arrears

- ***Timely accounting and reporting***
  - Accounting is comprehensive and timely
  - Reliable and timely bank reconciliation in place
  - Reports can be produced with minimal delay so budget execution can be tracked

  OUTCOME: Budget execution performance is known throughout the year allowing adjustment if required

- ***Central control over cash***
  - Use of a Treasury Single Account (or consolidated fund concept)
  - Minimal use of bank accounts and cash transactions

  OUTCOME: Budget minimizes use of cash and risk of financial irregularity

- ***Adequate internal control procedures***
  - Administrative internal controls in place in all government departments
  - Procurement is transparent with well defined regulations
  - Internal audit functions adequately

  OUTCOME: Budget execution avoids rent seeking behavior and financial irregularities

- ***Adequate external control procedures***
  - External audit addresses financial irregularities with timely reports to the legislature
  - Strong legislative scrutiny and follow-up on audit reports

  OUTCOME: Transparency and financial discipline enforced

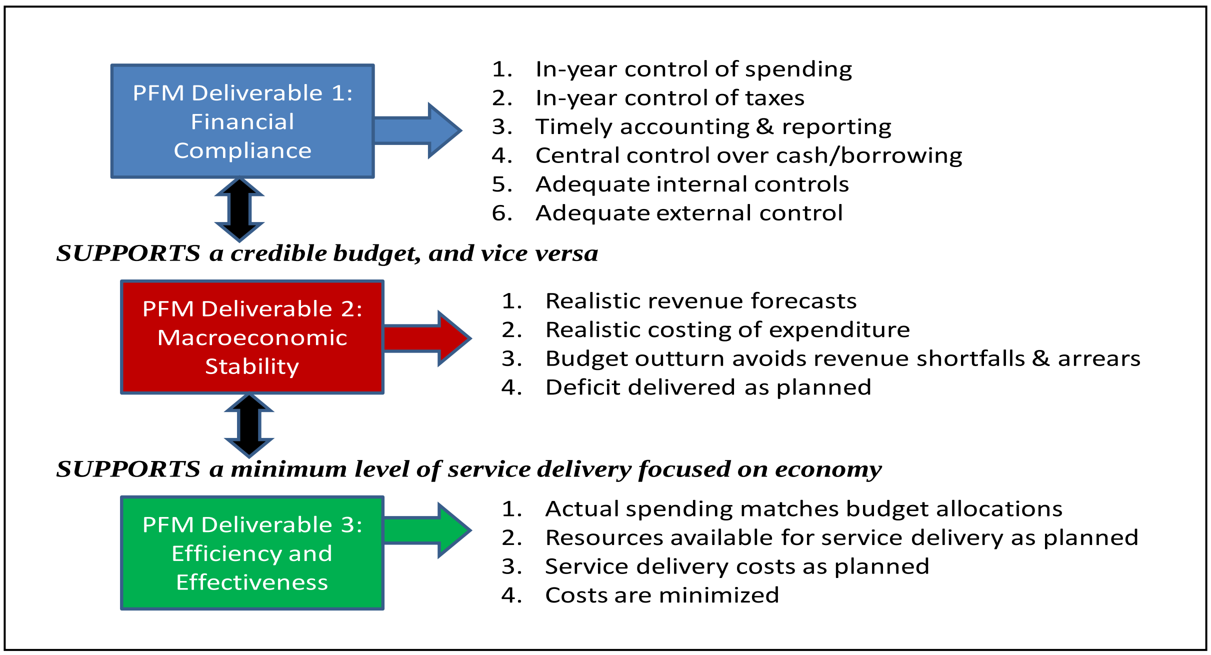
- ***Supporting legal and regulatory framework, that is adequately enforced***

  OUTCOME: The formal PFM system ***is*** the system

58. **The emphasis on financial compliance is not to the exclusion of other PFM deliverables and must be based on a firm regulatory base.** It should be stressed that although core PFM functions focus on compliance this does not mean other PFM objectives

are ignored. For example, starting with a realistic or "credible" budget not only provides a basis for macroeconomic stability but also provides a solid basis on which to enforce financial compliance. Compliance and stability in the resource base also allows services to be delivered up to the level foreseen in the budget. However, since the budget is input-oriented it is difficult to translate this into outputs and outcomes to ensure full efficiency and effectiveness in the resources used. The relation between core functions and PFM priorities is shown in Figure 4.1 below. It should also be recognized that the validity of adopting compliance as the core objective requires that it be based on a sound regulatory framework for PFM, which should be regarded as a first precondition. Defining critical requirements in laws and financial regulations to reach core levels of control is therefore a problem that also needs to be addressed in some countries. The second precondition is that this regulatory framework is enforced, so that the official PFM system is really the system in operation. Consequently, the problem of the existence of parallel or informal systems, which often exist in LICs, also needs to be addressed.

Figure 3.1 Aligning Core Functions with PFM Deliverables



Using the PEFA Analytical Framework to Measure Core Functions

59. **The second step in adopting core PFM functions as a reform objective is to specify the level these functions should reach.** To determine these desired operational levels it is intended to use the PEFA indicator scoring system. It should be recognized that in following this approach this paper relies heavily on the detailed analysis in Tommasi (2012), that is appended to this paper (Background Paper 2).

60. **It should be recognized that using PEFA as a measuring instrument is not without problems.** For example, the PEFA framework is difficult to align with the hierarchy in PFM reform priorities that has been previously advanced. Ideally, this would require PEFA indicators to be aligned hierarchically (essentially by giving PEFA indicators different weights depending on the higher level PFM outcome they most clearly contribute to). In this approach the PEFA indicators would be prioritized by allocating them to the three main stages of PFM development described in Figure 2.1 above. Countries would then be expected to be rated A, or close, on all first stage indicators—that could be identified as the "core" — before moving to the second and third stage indicators. In terms of identifying the "core" as the first stage, this approach has two problems illustrated in Box 3.2 that make it untenable.

61. **For the most part PEFA indicators focus on financial compliance and fiscal control, but sometimes not consistently.** Some PEFA indicators mix different priorities, in the sense they include some dimensions directed to financial compliance but other dimensions directed to say, macro-fiscal stability or others to allocative and effectiveness considerations. The most notable examples are indicated with an asterisk in Box 3.2, that summarizes previous discussion on the "basics". Perhaps not surprisingly these tend to fall into the PEFA framework's "cross cutting issues" section, indicating comprehensiveness and transparency, but also, (as in C (i)), include indicators addressing policy-based budgeting. Secondly, the majority of PEFA indicators deal essentially with different aspects of financial compliance and so can be felt to adequately cover the "core", but in doing so are not so useful for subsequent higher level priorities. For example, it is possible to classify almost all PEFA indicators in section C, dealing with different stages of the budget cycle, as addressing different aspects of financial compliance (see Box 3.2). This is a finding that parallels that of Quist, who used all 74 PEFA sub-indicators for his model, and found all contributing in some way to his first platform "fiscal discipline", with only 7 covering one other PFM outcome, and only 3 covering all outcomes (see Quist, 2010, p.20, Table 2A). It should also be noted that Tommasi, when identifying basic priorities also takes all 74 PEFA indicators, (excluding those he views as derived from other indicators), and gives suggested ratings for meeting basic PFM requirements (Tommasi, 2009, Annex 2 pp.89ff.). Perhaps not surprisingly his target ratings for developing countries are not completely aligned with those of Quist, and are quite far apart for some PIs (see Box 3.2 where both are compared).

62. **There is also the problem of deciding PEFA indicator scores to that would determine the level of core PFM functionality.** Even if the indicators that describe "core" functions have been identified, there is a further problem of coming to a generally accepted agreement on their scores that would be required to reach some "core" PFM level, as evidenced in Box 3.2. There are two ways to ease this problem, which it should be admitted is difficult to resolve completely. The first, is to gather a sample of PEFA target scores from a large number of PFM experts and work with their average ratings to define "core" PEFA scores, i.e., try to reach an empirical consensus. The second, is to empirically investigate country average scores on the PEFA indicators and set targets that reflect the stage of a country's PFM system development. By anchoring targets on actual PI scores would make

“core” targets perhaps more realistic. For example, it should be noted that in Box 3.2 both Tommasi's and Quist's scores for the basics include “A” levels scores, some of which are often not even attained by advanced countries. This raised the criticism that they have been overly ambitious in setting basic target scores. The empirical approach does, however, alter the interpretation of the “core”: it admits the concept is not absolute but relative, determined by relative differences in average countries' scores in PEFA assessments. To illustrate this, some 118 PEFA reports were taken and divided by each country's stage of development, the derived distribution of average scores on the PEFA indicators is shown in Box 3.3. It should be noted that, as might be expected, PEFA scores tend to increase through LIC to low MICs and through to high MICs, in almost all cases. Moreover, it should also be noted that the scoring is much lower than the previous “basic” targets set in Box 3.2, and hence supports the case that the latter may be too ambitious.

63. **A comprehensive revision of PEFA scores used in defining “basics” allows a better definition of “core” PFM levels.** To address the above issues Tommasi has taken the scores in his original 2010 study of the basics, and reviewed them in light of two main information inputs to determine the “core” levels. First, extensive comments by PFM experts on their preferences for “core” target levels were incorporated, and secondly the empirical evidence of countries' actual scores were used to test the “reasonableness” of the targets. The results of this extensive revision are contained in the tables shown in Background Paper 2, and summarized in the final column of Box 3.3 below. It will be noted that the result of this revision is to lower “basic” target scores relative to the new concept of core level functionality to better reflect PFM reality. But at the same time usually setting them above those scores currently attained by LICs and more in line with the levels of higher MICs, i.e., they are set at “realistically ambitious” levels.

Box 3.2. PEFA Indicators Allocated to PFM Stages and Target Scores for LICs

	PFM	Quist	Tommasi
	Stage	Target ratings	Target ratings
A. PFM OUTTURNS: Credibility of the budget			
PI-1 Aggregate expenditure outturn compared to original approved budget	1	A	R
PI-2 Composition of expenditure compared to the original	*1	A	R
Mostly compliance, but composition/sector control addresses allocative policy	*3	A	R
PI-3 Aggregate revenue outturn compared to original approved budget	1	A	R
PI-4 Stock and monitoring of expenditure payment arrears	1	A	R
B. KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency			
PI-5 Classification of the budget	*1	C	C
Introduces desirability of COFOG (functional) classification, addresses allocative issues	*3		
PI-6 Comprehensiveness of information included in budget documentation	*1	A	A
First three dimensions directed at macroeconomic issues	*2		
Ninth dimension deals with new policy initiatives	*3		
PI-7 Extent of unreported government operations	1	A	B
PI-8 Transparency of inter-governmental fiscal relations,	*1	A	B
First dimension deals with clarity on horizontal equity policy	*3		
second dimensions reporting for control	*1		
Third dimension addresses consolidated general government fiscal position	*2		
PI-9 Oversight of aggregate fiscal risk from other public sector entities	*1	A	C or B
Partly for control, and partly to correct net fiscal position	*2		
PI-10 Public access to key fiscal information	*1	A	A or B
Mostly for compliance, but seventh dimension partly deals with sector expenditure policy	*3		
C(i) Policy-based Budgeting			
PI-11 Orderliness and participation in the annual budget process	1	A	A
PI-12 Multi-year perspective in fiscal planning, expenditure policy and budgeting	2 & 3*	A & C	C
C(ii) Predictability and Control in Budget Execution			
PI-13 Transparency of taxpayer obligations and liabilities	1	A	B or C
PI-14 Effectiveness of measures for taxpayer registration and tax assessment	1	A or C	A,B,C
PI-15 Effectiveness in collection of tax payments	1	A	B
PI-16 Predictability in the availability of funds for commitment of expenditures	1	A	B
PI-17 Recording and management of cash balances, debt and guarantees	1	A	A or C
PI-18 Effectiveness of payroll controls	1	A	B
PI-19 Competition, value for money and controls in procurement	1	A	B
PI-20 Effectiveness of internal controls for non-salary expenditure	1	A	B
PI-21 Effectiveness of internal audit	1	A	C or D
C(iii) Accounting, Recording and Reporting			
PI-22 Timeliness and regularity of accounts reconciliation	1	A	A
PI-23 Availability of information on resources received by service delivery units	*1	A	A
Insofar as addresses supply of services and effectiveness of budget allocations	*3		
PI-24 Quality and timeliness of in-year budget reports	1	A	A
PI-25 Quality and timeliness of annual financial statements	1	A	C
C(iv) External Scrutiny and Audit			
PI-26 Scope, nature and follow-up of external audit	1	A or B	C
PI-27 Legislative scrutiny of the annual budget law	*1	A	A or B
Mostly compliance, but insofar as scrutiny covers macro, MT framework and policy priorities	2 & 3*		
PI-28 Legislative scrutiny of external audit reports	1	A	B

Sources: Quist, 2010, Table 6; Tommasi, 2010, Annex II.

R = “resulting” or derivative indicators; * indicates PI covers more than one PFM stage.

Box 3.3. PEFA Indicator Scores for Different Classes of Countries				
	(1) LICs	**(2) LMICs**	**(3) HMICs**	**(4) Core**
Numerical scoring: A= 4; B=3; C= 2; D= 1. Sample Size, N =	57	64	47	
PEFA INDICATORS:				
PI-2-(ii) Actual expenditures charged to contingency vote (new component) PI-4-(ii) Arrears monitoring	n.a. 2.0	n.a. 2.3	n.a. 2.8	 *
KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency				
PI-5 Classification of the budget	2.6	2.8	3.2	C= 2
PI-6 Comprehensiveness of information included in budget documentation	2.8	3.3	3.4	A= 4
PI-7 Extent of unreported government operations	2.1	3.0	3.5	B= 3
PI-8 Transparency of inter-governmental fiscal relations,	2.5	2.5	2.9	**
PI-9 Oversight of aggregate fiscal risk from other public sector entities	2.1	2.0	3.1	**
PI-10 Public access to key fiscal information	2.2	2.7	3.1	B= 3
POLICY-BASED BUDGETING				
PI-11 Orderliness and participation in the annual budget process	2.6	3.0	3.2	B = 3
PI-12 Multi-year perspective in fiscal planning, expenditure policy and budgeting	2.1	2.1	2.4	C = 2
PREDICTABILITY AND CONTROL IN BUDGET EXECUTION				
PI-13 Transparency of taxpayer obligations and liabilities	2.5	2.5	3.1	C+= 2.5
PI-14 Effectiveness of measures for taxpayer registration and tax assessment	2.2	2.4	3.0	C+= 2.5
PI-15 Effectiveness in collection of tax payments	2.2	2.3	3.0	C+=2.5
PI-16 Predictability in the availability of funds for commitment of expenditures	2.4	2.7	3.0	C+= 2.5
PI-17 Recording and management of cash balances, debt and guarantees	2.5	2.9	3.2	B= 3
PI-18 Effectiveness of payroll controls	2.1	2.6	3.2	C+= 2.5
PI-19 Competition, value for money and controls in procurement	2.3	2.3	2.3	C+= 2.5
PI-20 Effectiveness of internal controls for non-salary expenditure	2.6	2.8	3.4	C+= 2.5
PI-21 Effectiveness of internal audit	2.0	1.8	2.5	C= 2
ACCOUNTING, RECORDING AND REPORTING				
PI-22 Timeliness and regularity of accounts reconciliation	2.4	2.8	3.2	B= 3
PI-23 Availability of information on resources received by service delivery units	1.4	1.8	2.7	Not Basic
PI-24 Quality and timeliness of in-year budget reports	2.5	2.6	3.3	C+= 2.5
PI-25 Quality and timeliness of annual financial statements	2.3	2.9	3.0	C+= 2.5
EXTERNAL SCRUTINY AND AUDIT				
PI-26 Scope, nature and follow-up of external audit	1.8	2.3	2.8	B= 3
PI-27 Legislative scrutiny of the annual budget law	2.7	2.8	3.1	B= 3
PI-28 Legislative scrutiny of external audit reports	1.8	1.8	2.2	C+= 2.5

Countries by GNI per cap. LICs = $995 or less; LMICs= $996-3,945; HMICs 3,946-12,195; IBRD, 2009.
Basics in Col. 4. From Tommasi, 2012, Tab.2. Background Paper 2, p.35.
* Not all dimensions basic; ** = country specific, depending on degree of decentralization

64. **The result of this revision is that it is possible to define core PFM functions and their functional levels by PEFA scores**. By combining Box 3.1 and Box 3.3, we have the following description of PFM core functionality shown in Box 3.4:

Box 3.4. Core Functions and Their Target PEFA Scores	
Description of Core PFM Functions	**PEFA Indicators and Target Core Scores**
• ***Realistic budgeting*** - Revenue forecasts are realistic, based on detailed analysis of revenue bases and macroeconomic developments - Expenditures are fully costed, with adequate allowance for inflation, exchange rate movements, recurrent costs of completed investments	PI- 5 (C); PI-11 (B); PI-12 (C)
• ***In-year control over spending*** - Commitments are controlled as well as cash - Budget is comprehensive, and makes adequate provision for contingencies	PI-2-(ii) (B); PI-4-(ii) (B); PI-18 (C+) PI-6 (A); PI-7 (B);
• ***In-year control over revenues*** - Tax administration has capacity to enforce tax laws - Continual analysis and follow-up of revenue collections versus estimates	PI-13(C+); PI-14 (C+); PI-15(C+); PI-16 (C+)
• ***Timely accounting and reporting*** - Accounting is comprehensive and timely - Reliable and timely bank reconciliation in place - Reports can be produced with minimal delay so budget execution can be tracked and public sector monitored	PI-22 (B); PI-24 (C+); PI-25 (C+);PI-23(i) (D); PI-9(i) (B)
• ***Central control over cash*** - Use of a Treasury Single Account (or consolidated fund concept) - Minimal use of bank accounts and cash transactions	PI-17 (B);
• ***Adequate internal control procedures*** - Administrative internal controls in place in all government departments - Procurement is transparent with well defined regulations - Internal audit functions adequately	PI-19 (C+); PI-20 (C+); PI-21 (C)
• ***Adequate external control procedures*** - External audit addresses financial irregularities with timely reports to the legislature - Strong legislative scrutiny and follow-up on audit reports	PI-26 (C+); PI-27 (B); PI-28 (C+); PI-10 (B)
• ***Supporting legal and regulatory framework, that is adequately enforced***	Not covered in PEFA

65. **PEFA as a Tool for Determining Reform Sequence Has Limitations**. PEFA has limited ability to accommodate factors external to PFM. PEFA assessments deal with PFM functions in a standardized way, but cannot standardize or accommodate non-technical factors that are likely to exert a major influence on the success of any PFM reform path adopted. While it is true that the PEFA tool was not designed to take into account the institutional and governance framework in which PFM operates, ignoring such factors could question the realism of its ratings between countries. For example, the tool assesses formal PFM processes and institutional arrangements, regardless of how prevalent informal processes and/or gaming with the rules may be. In theory, these factors could be addressed in the narrative section of the PEFA assessment, but due to sensitivities of the national authorities this tends not to be too rigorous.[41] Rather, the PEFA narrative tends to provide a detailed description of the “formal” PFM system, as dictated by law and financial

[41] Allen also proposes that the institutional gaps could be covered by the World Bank’s “institutional and governance review”. However, as he indicates such reviews are typically resisted by national authorities (Allen, 2009, p.14).

regulation.[42] If it is regarded as impractical to include indicators for external factors that impact PFM processes at this stage of the PEFA framework's development, which is understandable, there does seem a case for devising some parallel assessment tool that will cover such factors. One possible solution is presented in Chapters below.

66. **While the PEFA analytical framework has been designed as a tool to assess the strength of countries' PFM systems, it has also increasingly been used as a basis for prioritization in PFM reform planning**. These two roles are sometimes not sufficiently differentiated. As a rating tool PEFA has a number of commendable attributes: it is standardized between countries, and over time; it covers all aspects of the PFM system; it is based on a analytical framework that treats PFM as a system delivering clearly defined outcomes; its ratings are based on advanced country good practice and identify, and scale, areas of strength and weakness for each country. The strength of this assessment is based on a detailed specification of PFM functionality, and because of this it has been argued above that it is a useful tool for determining PFM "core" functions and the target scores to reach core level functionality. However, as a tool on which to base PFM reform plans and determine sequencing of reform actions PEFA has some limitations:

- **The majority of indicators concentrate on compliance considerations, so that PEFA indicators alone will not be able to substitute for the higher level analysis and diagnosis required to determine what a country's top level PFM reform priorities should be**. Simply, the PEFA framework is not primarily designed to allow sufficient prioritization between different higher level PFM objectives and thus offer a guide to moving beyond the core.
- **A related weakness is that within "the core" it also allows limited prioritization**. This is a particular problem in low income countries where C and D (and even N) ratings are widespread. In these countries there are many examples of PEFA assessments that have been followed by "PEFA action plans". In these plans reform actions are identified to correct low ratings across a large number of dimensions, and so end up being so extensive as to strain the administrative capacity of these countries to implement all actions at the same time. Given their limited resources such countries need to prioritize, but PEFA does not allow this having no means of weighting some indicators above others as being more fundamental for reform.
- **Even using poor indicator scores as a guide to reform priorities is likely to be unwarranted without further analysis**. A poor score indicates a weakness but does not *explain* that weakness. The fact is that PEFA indictors are exactly that—they are indicators of underlying PFM processes. They indicate how well these processes are functioning according to some scaled criteria, but diagnosing a problem is not the

[42] It should be remembered that Schick warns that the problem with developing countries is not the lack of law, but the coexistence of dual systems—that distinction between formal and informal processes—in most areas of society, including government.(Schick,1998). For the case of Africa, Andrews (2010) provides some evidence for the importance of this factor.

same as suggesting a solution to the problem. This would require greater in-depth investigation of the underlying PFM processes. For example, a D score on the indicator for expenditure arrears (PI4) does not indicate whether this has arisen from unrealistic budget preparation, poor budget execution controls either on expenditures or revenues, untimely reporting , a limited accounting system, etc, all of which could contribute to the D score. For this reason Tommasi rightly designates some PEFA indicators, such as PI4, as derivative (or "resulting") from other indicators.

- **PEFA has some gaps in its coverage of core PFM functionality**. In his comprehensive review of PEFA in Background Paper 2, matching each indicator to core PFM functions, Tommasi (2010) noted three main deficiencies in the PEFA approach. First, PEFA offers no standards for financial legislation or regulation to ensure basic PFM functions are met and enforced. Secondly, while the existence of a certain level of IT appears essential to reach adequate core ratings in terms of the PEFA indicators, the assessment remains silent on what level of IT is recommended. Thirdly, there are a few technical PFM areas that are inadequately covered. For example, he highlights the maintenance of physical asset registers, regular reconciliation of treasury and line ministry accounts, line managers' control of payrolls, and more guidance/restrictions on below-the-line accounts and special payments procedures.[43] Certainly, there is a clear case for PEFA to review its treatment of these areas and offer some specific standards that countries should reach. The lack of adequate coverage of these areas, however, raises some questions for sequencing. For example, should the legal framework follow or lead reform actions, and in what specific ways should the regulatory framework evolve as countries move from financial compliance to higher level PFM objectives. In terms of IT capacity, questions are raised about how to introduce the capacity required to reach core PFM functionality, and what extra IT capacity would be required when moving on to higher level PFM deliverables. These issues are considered important enough to be specifically addressed in Chapter IV below.

67. **Reform sequencing should not rely on PEFA analysis alone.** The above qualifications should not detract from the fact that PEFA is a sound assessment tool, but rather they should provide some warning in using PEFA assessments mechanistically in determining the design and sequencing of PFM reform. It is suggested here that PEFA should be embraced as a diagnostic tool but not overloaded by simultaneously being used as a determinant of reform actions. This does not rule out further analysis of PEFA results as a guide to action, but only when complemented by other information. How this might function has already been suggested by previous approaches found in the sequencing literature.

[43] Tommasi, 2011, pp.10 ff.

B. Chapter IV: Step Two: Strengthening the IT, Accounting, and the Legislative Base for PFM Reforms

Summary: *This chapter reviews the necessary PFM requirements for moving beyond core functionality. It focuses on the need to establish a solid IT platform by introducing a financial management information system (FMIS); developing the accounting system to match evolving PFM needs, beyond simple recording of cash transactions; and strengthening and modifying the PFM regulatory framework . All such reforms would further strengthen financial compliance and should be considered preconditions for moving "beyond the core". Further requirements in these areas to support these subsequent reforms are also indicated.*

Establishing a Solid Platform for Moving "Beyond the Core"

68. **The first step before moving to more advanced PFM reforms is to ensure a stronger compliance platform.** PFM core functionality has been defined in this paper by scores on the PEFA indicators determined by Tommasi's detailed analysis (Background Paper 2). Those core level scores revealed several indicators far below an "A" score (see Chapter III), indicating further improvement in those scores would take a country "beyond the core". Since the vast majority of PEFA indicators cover different aspects of financial compliance (or fiscal control), this implies many reform actions required to move beyond the core would be those to further strengthen financial compliance. This, it is argued in this chapter, can be accomplished by:

- **Strengthening the CIT basis of budget management.** Improved automation of PFM functions can considerably improve the system's capacity especially in regard to timeliness and comprehensiveness. It will be noted that improvements in these dimensions typically improve PEFA scores on a wide range of indicators, indeed often an "A" score in some indicators would be near impossible to attain using manual systems. For this reason this chapter focuses on the importance of a modern FMIS. This is regarded as a precondition for moving further beyond PFM core functionality. It is stressed, however, that a fully functioning FMIS involves more than automation, but requires many supporting PFM auxiliary functions to perform effectively.
- **Developing the accounting system.** One of the most important supporting functions complementing the development of an FMIS is the underlying accounting system on which it rests. It is argued that it is important that in its day-to-day operations the accounting system will be able to record more than just cash transactions. This does not argue for the introduction of full accruals, rather the accounting system should match the information requirements demanded by the PFM system's stage of development. As the PFM system develops beyond the core, it is argued, then accrual concepts will become more relevant. As a first step countries should try to meet IFSAS Cash reporting standards, at least for central government, which should be regarded as a baseline requirement for any PFM system to move beyond the core.

- **Reinforcing the regulatory basis governing PFM.** Many PEFA indicators because they refer to compliance, can only attain a high level of compliance (i.e., high scores) if existing legislation and financial regulations are adequately rigorous in their demands *and* fully enforced. Unfortunately, as Tommasi has pointed out, PEFA has not specified the regulatory requirements to reach core PFM levels. He does, however, offer a checklist of necessary elements, which this chapter builds on to establish a baseline regulatory framework required to meet the core level. The chapter also explores how this framework will have to be supplemented to meet PFM requirements for moving beyond the core.

69. **If these three main areas are adequately addressed, the financial compliance objective of PFM will be substantially satisfied.** Countries can then use this as a platform to move to more advanced PFM deliverables: the move from annual to multi-year budget planning (discussed Chapter V), and then the introduction of reforms to improve efficiency and effectiveness in government operations (discussed Chapter VI). The sequencing of PFM reforms beyond the core can be viewed as a three track process pursuing ever more effective PFM delivery, with relative progress down each of these tracks determined by individual country preferences. This is pictured in Figure 4.1 below. There are, however, limits to the relative speed at which countries should progress down any one of these three reform tracks. Getting out of step and over-reaching in reform initiatives should be avoided. For example, the financial compliance regime for a decentralized performance budget system differs from that of a traditional centralized budget system. It would be dangerous to introduce the former until accountability in performance budgeting can be assured. It would also be unwise to advance medium term budget planning to an MTEF without parallel reforms in program budgeting being adequately developed. Rather, moving in tandem down the three tracks should follow the previous prescription for sequencing priority: get financial compliance in place before advancing medium term budget planning, and similarly secure the latter to an adequate level before attempting to introduce the most advanced reforms like performance budgeting.

The IT Basis for PFM Reforms

70. **The IT basis of PFM must evolve as the PFM system evolves.** The impact of the global CIT revolution on the business of government, even in the poorest of LICs, has become ever more pervasive in the past two decades. Consequently, the question is raised on the role of IT in sequencing PFM reforms. This issue is addressed in three parts: the level of IT required to attain core PFM; the **level** that should serve as a precondition for moving PFM reform beyond the core; and the subsequent IT requirements demanded by reforms beyond the core.

Figure 4.1. Three-Tracked Sequencing of PFM Reforms beyond the Core

The IT requirements to reach the core level.

71. **Unfortunately, despite its emphasis in PFM reform, the PEFA framework does not deal explicitly with IT requirements.** However, there can be no doubt about the dependence of good PFM on adequate IT support. Indeed, the global revolution in this technology coupled with vast improvements in communications has seen its increased application to PFM. A recent study by the World Bank has examined 30 developing and middle income countries' MOFs, and has identified that 20 of these countries have some form of intranet or knowledge exchange. Moreover, it was also noted that specialized agencies—such as tax, customs and procurement authorities—are even more likely to use email and an intranet.[44] Alongside the advances in communications, knowledge and skills in software applications has also mushroomed in these countries, providing most MOFs a solid basis to introduce ever more sophisticated automation to PFM functions. It is no surprise, therefore, to find that many countries have fully computerized core PFM procedures and have introduced government-wide financial management information systems (FMISs). For example, a recently launched World Bank web-site that deals solely with the design and implementation of FMISs covers some 94 projects from 54 countries.[45]

72. **Despite the absence of any formal guidelines, it seems evident that some level of IT is required to attain satisfactory scores in PEFA indicators, even to reach PFM core levels.** In reviewing the scores suggested by Tommasi for adequately fulfilling core PFM

[44] "Lessons of the CFA Study for the World Bank and other Donors", Richard Allen, 2011.
[45] As of December 2011, see FMIS CoP website, (https://eteam.worldbank.org/FMIS).

requirements it is difficult to see how some A scores could be reached without some application of IT. For example, budget monitoring of the stages of the execution process (PI 24), as well as arrears recording and timely reporting (PI4), and controlling commitments (PI 20), are all tasks much facilitated and perhaps dependent on the use of IT. Similarly, the effectiveness of the tax collection (PI 15) is dependent on the issuing of taxpayer IDs, the maintenance and analysis of taxpayer data bases, and the ability to relate these data bases between different taxes paid (e.g., customs and excises with direct taxes). All such functions have been much facilitated by standard software packages (e.g., ASYCUDA)[46]. No area has more obviously benefited from custom software packages as the government's accounting system, which can be regarded as an essential contributor in meeting other PEFA PIs: the regularity and timeliness in accounts reconciliation (PI 22), the quality and timeliness of accounting and financial statements (PI 25), and in turn the timeliness of audit statements (PI 26).

73. **Even the PEFA indicators on donor practice, which do not deal directly with local PFM processes, do have indirect IT implications for the host country.** For example, D2, concerning the financial information provided by donors on project aid, requires this to be captured, up-dated regularly by the host country, and be reported on. IT is also essential to address some gaps that Tommasi has identified in the PEFA assessment. For example, controls on payroll that require data bases on cash payments to be matched with HR profile databases, and the registering of physical assets of government, would be difficult without some IT application.

74. **The nature of the technology allows many solutions to the IT requirements of PFM. While** the importance of IT cannot be denied, it should be acknowledged that core PFM requirements—as indicated by Tommasi's target PEFA PI scores--could be met by off-the-shelf software and stand-alone applications (sometimes no more than linked spreadsheets), rather than more sophisticated integrated management systems. There are many countries that operate stand-alone software solutions for a number of core PFM functions. Among these systems are: the payroll system; cash flow planning; budget planning; debt and aid management; revenue administration; procurement; project management; asset registers. However, as previously indicated, appreciating the efficiency of a more integrated approach a large number of countries have attempted to interface many of these software applications with a central accounting software package to develop integrated financial management information systems.

The IT platform for moving beyond core levels.

75. **FMISs have been recognized as a critical PFM reform in a wide range of countries in order to meet the requirements for a fully compliant budget system.** Certainly it is difficult not to agree with the argument that this more integrated IT approach is

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[46] A standardized international software that allows electronic interface between clients and the customs administration, on-line processing, analytical tools as well as risk assessed audits.

essential to accommodate necessary PFM requirements when moving beyond financial compliance objectives.

76. **While the term has been interpreted differently between countries, among the common attributes of a FMIS are:**[47]

- It should provide a common platform and user interface to participants in PFM in different agencies to allow them to input and access a core information database.
- The core information data base, maintained by the system, should include: all budget revenue and expenditure estimates; in-year transactions data at the greatest level of detail; cash flows and bank account operations (including checks issued, cancelled and paid); cash balances and floats.
- The data base should allow compilation of formal government accounts, avoiding the need to duplicate data entry for any accounting purpose.
- The system should enable real-time reconciliation of parallel and related streams of transactions data: at the agency level, to reconcile bills received with payment orders issued; at the central treasury level (assuming a centralized payment system) to reconcile checks issued with those paid by the banks as well as to reconcile receipts from banks with the checks paid by taxpayers; by so doing, reconcile cash availability reflected in the agency electronic ledgers with the cash balances at the banks.
- It should mechanize all possible routine tasks at the central and spending agencies: generating various forms/authorizations, issuing checks, outputting hard copies of key accounting registers and statements.

77. **In fulfilling these functions, the foundation of the FMIS is the government's accounting system, which in turn through its chart of accounts (COA) determines the way transactions are recorded in the system.** Thus core functions of the typical FMIS are based on the principal accounting modules: the general ledger, budgetary accounting, payment orders, accounts payable and receivable. It should be noted that even if the government's accounting system is cash based, for adequate control over cash disbursement the system should allow the tracking of all prior stages in the spending process: from the budget appropriated amounts, any in-year changes to these authorizations, all commitments made against appropriations, obligations that have arise without checks issued, checks issued against obligations but not yet cashed (see first column Box 8.1). In this way the system can impose electronic checks on the regularity of the transactions, and monitor and report on such important aspects of PFM such as commitments made, cash available and any arrears being generated.

78. **Introducing an FMIS requires more than just automation.** Information should be in real **time**, or with minimal lags, so that at the end of each business day the treasury should

[47] For a most comprehensive treatment of functionality see The World Bank Treasury Reference Model, Allen and Hashim, 2002.

have available information on its cash position and a picture of future cash needs that are being generated in the system with which to plan its treasury operations. In addition, this basic budget execution functionality will be supplemented with a dedicated cash flow module recording cash flows on a monthly, rolling short-term (1-3 months) and longer (three-months/year-end) basis. Ideally this should be integrated or at least interfaced with the treasury's debt management module recording financing flows and outstanding debt as well as the payroll, revenue administration and procurement software sub-systems. As a consequence, the introduction of an FMIS should be viewed as more than merely automating the PFM system, but must be supported by other PFM functions in order to operate effectively, as indicated in Box 4.1.

79. **Introducing an FMIS requires parallel development of other PFM processes.** Obviously, such a fully integrated system will assist greatly in meeting a large number of PEFA PI targets. However, the converse is also true—the PFM system must be at a sufficient level in its development to support an FMIS. It can be argued that a successful FMIS requires countries have reached "core" PFM levels on most of the dimensions outlined previously (see checklist in Chapter III).

- **First and foremost there must be sufficient internal controls and financial compliance for a FMIS to function properly.** Revenue departments must speedily deposit receipts at the bank and reconcile their collections with these deposits. While some controls on expenditure can be introduced electronically, for them to be effective line ministries must process all their transactions through the system, in a timely manner. Too often one finds countries where line ministries attempt to avoid the discipline of the FMIS, overriding controls, delaying entering transactions into the system, or even circumventing the system by opening bank accounts, say to utilize grant funds without Treasury control.[48]
- **Secondly, an FMIS works most efficiently with a TSA, since a large number of bank accounts requires many more reconciliations.** Multiple accounts slow down the bringing of transactions to account and usually create many errors between the general ledger and bank data. From a compliance viewpoint, regular and timely bank reconciliation is the Treasury's strongest control mechanism to ensure against material misstatement of accounts, loss of funds through banking errors or omissions, and even fraud.

[48] These are some of the gaps that Tommasi has identified in the PEFA framework, Tommasi, 2011, p.10.

BOX 4.1. The Introduction of a FMIS in PFM is more than just Automation

Core functions: controlling, recording & reporting on all stages of spending:	**Other controls imposed, usually internally, within the system:**	**Other complementary PFM functions for an efficient FMIS:**
Approved appropriations ↓	Record any in-year changes (virements/supplementaries)	Central budget management
Release of appropriations to line ministries (LMs) ↓	Impose allotments to limit spending in a given period	Central planning of budget execution
LMs enter into contracts/ issue work orders ↓	Impose commitment limits based on cash forecasts	Central cash planning to forecast cash availability
Wages, pensions, debt service paid according to schedules ↓	Integrated payroll and debt management sub-systems	Personnel records and payroll integrated/accurately maintained
Goods & services delivered/ verified ↓	LM internal control	Active budget managers in LMs using the system to process all transactions in a timely manner;
Bills/Invoices received ↓	LM internal control: bills must match orders	System generates custom management reports
Payment orders/vouchers prepared and issued ↓	LM internal control: Payment orders s must match bills	for LMs and central budget office
Payment made via cash, check or electronic transfer ↓	Automatic generation of checks/ transfers	Active cash management through a Treasury Single Account
Cash debited from government accts. ↓	Cash position monitored daily by Treasury to ensure payment	Active cash management with integrated debt and aid management
Transactions recorded in accounts	Automated bank reconciliation with govt. banker: debits must match vouchers	Limited use of B-T-L accts; accounting standards adhered to

- **Secondly, an FMIS works most efficiently with a TSA, since a large number of bank accounts requires many more reconciliations.** Multiple accounts slow down the bringing of transactions to account and usually create many errors between the general ledger and bank data. From a compliance viewpoint, regular and timely bank reconciliation is the Treasury's strongest control mechanism to ensure against material misstatement of accounts, loss of funds through banking errors or omissions, and even fraud.
- **Thirdly, the accounting system must be working effectively.** This is necessary to prevent errors in coding, and to avoid short-cuts like suspense, and other below-the line accounts, which often remain un-reconciled, and that can substantially distort the

government's cash flow position and prevent successful automation of the reconciliation process.

- **Fourthly, a FMIS's ability to successfully execute the budget depends on parallel skills in cash management and other Treasury operations.** These operations, such as debt and aid management, are considerably complicated without a TSA and poor accounting.

80. **The extensive list of preconditions indicates the degree to which core functions must be met before one can expect a FMIS to function properly.** Further, it is important not to discount the difficulties in introducing FMISs into insufficiently developed PFM systems. As indicated, in recent years FMISs have been much promoted by donors as an important reform in their own right. Indeed, for many LICs PFM reform appears to have been IT led, so that the introduction of IT into government has come to be viewed as a reform objective rather than a vehicle for other reforms. The attraction of the FMIS approach is not difficult to appreciate: for countries it copies modern systems found in more advanced countries and for donors it represents a clearly identifiable reform package, based on a standardized project design that can be replicated across countries. Despite their popularity, the experience of introducing government-wide FMISs in LICs has not been without difficulty and often has not been totally successful.[49]

81. **One important reason for implementation problems has been the failure to reform underlying PFM processes before applying IT.** Often this is evidenced by the processes dictated by **the** FMIS software being superimposed on existing manual budget management and accounting procedures that are not fully aligned with them. Another cause has been the attempt to be too ambitious—failing to appreciate the degree of HR skills required to implement and maintain these systems, and the time it takes budget participants to change their traditional ways of doing business.[50] To maximize the returns from using a FMIS it is essential to review all business processes, redesign them to allow maximum automation and prepare a plan for implementation of the redesigned processes. It should be noted that in terms of its risk profile, (as discussed in Chapter X), a FMIS reform project displays all the worse elements for successful implementation: it is de-concentrated, involving a large number of institutions, takes time, its scope is wide and requires a significant degree of behavioral as well as procedural change to succeed. As a consequence it requires a high level of change management skills. The effort required in the design of the FMIS, its configuration to meet country needs, and the re-engineering of existing business processes and their implementation, can be appreciated in a recent World Bank Study documenting the stages involved in following this approach and the lengthy period of time required (see summary in Box 4.2).

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[49] See case studies in FMIS CoP website, (https://eteam.worldbank.org/FMIS), the review by Dener et al, World Bank,2011,and for some earlier experiences, Diamond and Khemani, 2005.

[50] The approach to introducing FMISs, and the problems encountered, is dealt with more fully in Diamond and Khemani, 2005.

Box 4.2. Sequencing the Design and Implementation of FMIS Projects

1. Identify the FMIS needs of the Government

- Assess *existing capacity and practices* (e.g., PEFA, FMIS Questionnaire) to identify strengths, weaknesses and possible improvements.
- Assist in the development of a *PFM Reform Strategy* (if not available), setting government priorities and operational needs, together with the Government.
- Develop the *Conceptual Design of an FMIS* covering the functional review of PFM organizations, the recommendations for improving the institutional capacity, and the definition of FMIS functional modules (business processes and information flows), together with necessary procedural and organizational changes needed.
- Provide *advisory support and training* on FMIS and related PFM reform needs.

2. Develop customized solutions

- Assess *existing ICT capacity*.
- Develop an *ICT Modernization or e-Gov Strategy* (if not available).
- Develop the *System Design* to define FMIS functional requirements, technology architecture (network infrastructure, application software, central servers and data storage, field hardware, engineering systems, security, system/network mgmt and support) and implementation method, in line with the Conceptual Design.
- Prepare realistic *cost/time estimates*, as well procurement/disbursement plans.
- Identify the *FMIS prerequisites* to be completed before the signature of contracts with FMIS ICT system developer(s).
- Develop the detailed *Technical Specifications* for all ICT systems in line with the System Design, and related procurement packages (one-stage or two-stage ICBs).
- Coordinate with *e-Government initiatives* and other large scale public ICT projects to ensure compliance with interoperability standards and share common resources.

3. Strengthen institutional capacity to manage project activities effectively

- Form a *Project Management Group (PMG)* composed of key managers from all stakeholder groups. Establish a *Project Implementation Unit (PIU)* within the client's organizational structure for building/strengthening institutional capacity for project preparation and implementation (based on existing country systems, if possible). The PIU is expected to provide administrative and procurement support to the PMG.
- Promote the use of *country systems* for (a) coordination and administration of large scale investment projects; (b) financial management, accounting, reporting, auditing; and (c) procurement (if country standards are in line with the Bank guidelines).
- Prepare *draft ToRs* (selection of consultants) and *ICB documents* (technical requirements for supply and installation of FMIS ICT solutions) before the Board approval, if possible.
- Establish *mechanisms for monitoring and evaluation* (M&E) of project implementation, procurement and financial management activities (surveys, maturity framework, etc.). Clearly define the measures of success for the project.
- Design key activities for *capacity building and change management*.

These stages are expected to be mostly completed during the preparation of FMIS projects, ideally within 18-24 months. Including the project approval and effectiveness periods, the total duration before the initiation of the procurement phase of the FMIS solutions may be around 2-3 years minimum. However, it is extremely important to develop a realistic project design and initiate capacity building and advisory support activities at early stages to minimize implementation risks. Many FMIS projects benefit from the Project Preparation Advance (PPA) or donor grants for funding the preparation activities until project effectiveness.

Source: Cem Dener, Joanna Watkins, William Dorotinsky, 2011, *Financial Management Information Systems: 25 Years of World Bank Experience – What Works and What Doesn't*, World Bank.

82. **Despite implementation difficulties an FMIS is an important benchmark for PFM functionality and reform capacity.** Two conclusions emerge from this discussion of FMISs. First, it is difficult to envision a fully compliant budget system that lacks the functionality that a FMIS provides. Accordingly, it can be argued that the establishment of a fully functioning FMIS should be viewed as a precondition for moving ahead on higher level reforms.[51] Secondly, in many ways a FMIS can be viewed as a benchmark for reform capacity. It could be argued that if countries are unable to implement a FMIS, or are experiencing great difficulties in its implementation, then this may be an indicator that they should be discouraged from moving to further reforms beyond the core. That is, while introducing a FMIS should be seen as a necessary condition for fully attaining the primary objective of financial compliance, it should be seen as a necessary and sufficient condition for moving to the higher level PFM reforms associated with multi-year budget planning and fulfilling efficiency and effectiveness objectives.

The IT requirements to go beyond the core level.

83. **If well designed, a FMIS system should be modular and in this way be capable of progressive up-grading to cater to future needs associated with higher level objectives.** Again, these up-grades could be phased in.

84. **Up-grading the system to move to a MTBF would require a dedicated module.** This **would** handle the forward estimates of revenues and expenditures (prepared by the ministries/agencies), and resulting cash flows, allowing up-dating each year as the estimates are rolled over. These requirements should be supplemented with built-in analytical tools to offer trend analysis of various elements of fiscal operations to permit a forward look at emerging events bearing on the fiscal stance.

85. **Up-grading the system to move to performance budgeting would considerably increase information requirements.** The COA would include a program classification, and the system would record all transactions against cost centers, programs and activities, as well as on an economic and institutional basis, as detailed in the budget approved by parliament. It would record against the allocation of funds the desired results described in physical as well as financial terms, with an information system to capture agreed performance measures and to allow indicators for their achievement to be tracked. More fundamentally, the move to performance budget management may require a change in the government's accounting system. Countries with advanced performance budget management systems have recognized that an accounting system that allows tracking different stages of spending does not go far enough. For a comprehensive approach to budget management, which stresses performance, there is also a need to account fully for government assets and liabilities, to include all costs of providing services, and so move government accounting closer to private sector accounting, with similar types of financial statements. The move to full accruals on a

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[51] This is in agreement with Tommasi that "developing an FMIS should not be considered as a basic measure", (Tommasi, 2011, p.5), but rather as a requirement for high level reforms.

government wide basis has only been attempted by a few countries and has universally proved difficult and time-consuming.[52] Consequently, it is argued below this reform should be sequenced in line with the broader development of the PFM system.

The Accounting and Reporting Requirements in PFM Reform

Matching accounting needs to PFM development

86. **The choice of accounting regime is an important aspect in the design of any FMIS**. As noted, this was unfortunately not specifically addressed in Box 3.2. The heart of the FMIS is the accounting system and, since most FMIS government software has been adapted from private sector applications, there is often the option of adopting an accrual basis of accounting in such systems. The accrual basis recognizes transactions when the originating economic events occur, rather than when cash is received or paid as in cash basis accounting traditionally used in government. Certainly, there are considerable advantages in moving to accrual accounting on all dimensions of PFM deliverables: it widens the scope of financial compliance, including assets and liabilities as well as cash; it provides better financial information on fiscal stance and longer term sustainability; and allows stronger enforcement of managerial efficiency at an agency level by capturing the full costs of government activities. However, these advantages come at a price: the approach usually requires comprehensive FMISs to be in place, considerable technical expertise to introduce and manage the system, and takes considerable time and resources to transition the accounting regime from cash to accruals. The latter has represented a major and difficult project for most governments, even in advanced countries, that have attempted it[53].

87. **An accounting system should provide adequate information as the PFM system develops and these needs grow.** Previously it has been argued that PFM systems are not created overnight, but have evolved, by passing through distinct stages—from compliance to performance-oriented systems—implying that this transformation has been accompanied by ever-more sophisticated information requirements. As budget management systems have developed they have adopted more comprehensive budget management objectives. To meet these objectives requires more sophisticated and comprehensive information that has put increased demands on the accounting system. The accommodating evolution in accounting required to meet these information and reporting requirements could be viewed as a progressive move from a cash basis accounting, through a modified cash/modified accrual basis, then to full accruals. As in other aspects of PFM reform, this development should be seen as one of accretion—adding to accounting requirements to meet emerging PFM demands rather than substituting one accounting system for another.

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[52] For a description of a possible approach to sequencing this reform, see Diamond, 2006, Chapter 6.

[53] Hence Khan and Mayes come to the conclusion that ..."for many countries the capacity to implement an accrual-based accounting system is severely constrained by a lack of resources, particularly accounting and IT skills and a modern GFMIS. For these countries, full implementation of accrual-based systems, therefore, should be viewed as a long-term objective". (2009, p.15).

88. **Unfortunately, in the comparisons between cash and accruals there has been a temptation to engage in a spurious debate on the virtues of the different systems.** Since accrual accounting allows the generation of cash accounts, these systems should not to be regarded as substitutes. Rather the decision whether to move to accruals should be focused on two main considerations. First, on why there is a need for the increased information derived from accrual accounting. It will be argued here that this depends on the level of PFM system development that determines the need and the ability to use this increased information. Secondly, recognizing the introduction and maintenance of accrual accounting is a costly exercise for governments, (especially in countries where accounting expertise is scarce), it is important to explore possible intermediate solutions, or alternative more cost effective ways, of gaining some of the benefits afforded by accrual accounting. It will be argued there are alternative accounting regimes, intermediate to full accruals that perhaps better suit the needs and constraints faced by less advanced PFM systems.

89. **Accounting requirements should be determined by the stage of PFM system development so that the accounting function serves rather than leads PFM reforms.** The converse of this argument also holds: that to be effective, and to derive maximum benefits from accrual accounting, necessitates other features of an n advanced budget management system to be in place. It is recommended that the move to full accruals should only be contemplated by countries which have considerably advanced PFM systems: whose cash-based systems already function at a high level; have available the required expertise to introduce and maintain such an accrual system; and whose PFM systems require the improved financial information that accruals offer. These should be considered countries that are ready to introduce a performance management system within government. Indeed, implementation of an accrual-based system for government accounting, given the costs involved, is perhaps only worthwhile in the context of such an overall transformation of public sector management.

Sequencing Accounting Reforms

90. **It is useful to examine a typical development path for accounting systems.** In this way countries contemplating accounting reforms may learn from the experience of the countries that have followed this path and so better plan the transition process. A possible strategy for sequencing the reform of government accounting systems can be described in the following steps:[54]

91. **Stage one: *Get cash accounting to work well.*** This usually involves a two-pronged approach. First, purge the system of common abuses,[55] and second, supplement the cash accounts with adjustments to improve fiscal reporting. These adjustments can be made to an existing cash-basis accounting regime. For example, there is a strong argument that accrual accounting greatly assists in identifying emerging liabilities such as unfounded public service

[54] This is based on sequencing by task areas. Another approach is that of sequencing by sector, or importance (or "materiality") of entities, is discussed in Khan and Mayes, 2009.

[55] Documented in Diamond, 2002 , pp.6-7.

pensions, but multiyear cash-based expenditure plans can also highlight the problem. Similarly, most cash systems are weak in providing information on payment arrears, a problem often encountered when macroeconomic stabilization becomes an issue. A logical step is to add on systems that can generate information on bills payable and bills due for payment. These adaptations of the cash system would lead to the next stage of the accounting system's development—a modified accrual system.

92. **Stage two: Integrate operating accounts and financial asset and liability accounts—to move to modified accrual.** Integrating asset and liability and operating accounts would represent a significant step forward in transparency and accountability of government operations. It has the advantage of assuring that all transactions are treated in a consistent, self-balancing framework. The essential first element of this adjustment of cash accounts will be to include payables and receivables:

- **Accounts payable.** This will allow for the recording of liabilities that have not resulted in the payment of cash in the current accounting period. It would include goods delivered but not paid for and agreements to pay subsidies and grants to the private sector.
- **Accounts receivable.** This would allow for the recording of revenue earned by the government that has not resulted in the receipt of cash although it is sufficiently close to cash to be reasonably secured. It would include taxation and non-taxation revenue including credit sales of goods and services.

93. **This second stage should be regarded as a reasonable target for developing countries, recognizing that any movement to incorporate the above accrual concepts will provide more useful information for fiscal policy makers.** For any one country it should be possible to identify a series of steps towards modified accrual that would represent a logical transition path to meet its specific information requirements. It is envisaged countries would move progressively towards a system based on cash recording and reporting, but with an integrated set of operating and financial asset and liability accounts. It would achieve some of the operational advantages of integration, while avoiding the additional complexities of maintaining accounts on a full accrual basis. Box 4.3 indicates some of the elements involved. Even at this stage efforts should made to build up HR and IT capacity to successfully implement and maintain the new accounting approach. At the same time there should be an "education program" instituted for stakeholders, so that politicians and top government officials can come to terms with the increased complexity of the new reporting requirements.

Box 4.3. Steps in Moving to Modified Accruals

Adopt a classification structure that facilitates the recording of revenues, expenses, assets, liabilities, and cash flows to generate required reports (see discussion of IFSAS and GFSM 2001 below).

- Ensure the general ledger is based on a double-entry system
- Explore best option for recording and reporting selected assets and liabilities.
- Generate and agree trial balances.
- Establish a process of reconciliation of assets and liabilities in the general ledger with subsidiary records, such as accounts receivable and payable and fixed assets.
- Similarly, reconcile accounts with independent third party information where available (e.g., ledger balances with bank statements)
- Publish statements of contingent liabilities and outstanding commitments as part of budget documentation.
- Establish and train an asset valuation unit, which would develop appropriate valuation methods and value all government financial assets.
- Develop a statement of government financial assets (initially at historic cost, unless market valuation has been established), including investments in all parastatals, and liabilities.

94. **Stage three: Introduce more elements of accrual recording and move to a partial accrual presentation in ex post reporting.** At this stage the additional elements of accruals that could be recognized include:

95. **Provisions for employee entitlements**, such as pensions (linked to years of service and leave) as the employee earns them. Such entitlements have been generally shown to be a significant hidden cost of government that result in large unfunded demands on budget resources in future years. Recognition of the buildup in such demands through provisioning provides budget managers with useful early warnings of possible future problems in the cash funding of these entitlements, and enables corrective action to be implemented.

- **Prepayments received by government.** These receipts can range from deposits on the sale of assets to installment payments on the provision of government goods and services. Such receipts can be used to inflate the fiscal result for the current accounting period and consequently understate the fiscal result for future periods. However, since conditions have not been met for their recognition as government revenue, they should not be treated as revenues, but shown as financial transactions affecting assets and accounts receivable.
- **Interest payable.** Interest on debt can be a significant drain on budget resources and simply recording interest as it is paid may not provide adequate information on future trends in interest payments and whether they will place acceptable demands on budget finances. This is particularly the case with zero coupon bonds. This information would be seen as complementing expenditure control and the level of funds held in government bank accounts.

96. **At this stage of the move to accrual accounting, ex post reporting of the budget would include a partial balance sheet with selected financial assets and liabilities, and the adjusted cash flow operating statement would include some items on an accrual basis.** To undertake this work will require the selection and application of appropriate accounting policies consistent with international accrual accounting standards, developed by the IPSAS Board (which for the most part is harmonized with GFSM 2001). This will require expanding the COA to include assets and liabilities, and to cover those additional segments that may be required by a more advanced PFM system (e.g., cost centers, programs, projects, outputs and outcomes). Typically, at this stage, due to the increased workload arising from the recording and reporting on accrual transactions and balances, countries tend to devolve day-to-day accounting from the MOF to the line ministries (although the setting of policies and standards would remain under central control). In line with this move, and given the complexity of accrual accounting with the inherent possibilities for manipulation, it would be also prudent to strengthen systems in place to police the accounting system (e.g., special reporting requirements from external audit).

97. **Stage four: Recognize nonfinancial assets—final stage for accrual accounting.** This transition from recognizing only financial assets to recognizing both financial and nonfinancial assets greatly complicates the accounting process. It requires detailed asset registration and up-dating systems, agreed rules for depreciation and maintenance allowances, procedures for managing inventories etc. This requires consistent valuation (and revaluation) practices to be applied to all government nonfinancial assets—many of which are not easily subjected to a market-related assessment of value (e.g., the extreme case of "heritage" assets). Once this task has been completed, depreciation can be charged as an expense for each accounting period, so providing a better indication of the full costs of government operations. This stage, even for the most advanced OECD countries, has not proved easy. Only at this stage would full accrual ex post reporting be introduced to include:

- operating statement of performance showing how revenues and expenses explain the movement in the net stock of assets;
- balance sheet of financial position for the beginning and end of the accounting period;
- cash flow statement showing cash flows embodied in assets, liabilities, revenues, and expenses clearly distinguishing between operations, investment activities like loans, and advances and the financing of cash flows through the issue of government securities.

98. **Stage five: Move from accrual accounting to accrual accounting and budgeting.** This stage is **included** here for completeness, even though accrual budgeting should be differentiated from accrual accounting. Most comprehensively defined, accrual budgeting implies the application of accrual principles **to** the preparation, presentation, approval and appropriation of the budget. Currently, a handful of countries prepare and present their budgets on some version of accruals (Australia, Canada, Iceland, New Zealand, Switzerland,

UK), but fewer countries meet all these comprehensive requirements.[56] For example, even if budgeting is accrual-based countries typically do not appropriate, at least entirely, on an accrual basis. Some use only cash (Canada), others adopt a mixed procedure (UK), and some countries with mixed procedure have noticeably evolved their approach with experience (e.g., Australia). Others may report on an accruals basis ex post, but budget (and also report ex post) on a cash basis. For example, Switzerland uses accruals for ex post reporting but employs cash measures when setting fiscal policy, while Canada applies accrual fiscal indicators at the aggregate level but not at the agency level.[57] It should also be noted that there are several countries that have moved, or are moving, to accrual accounting, but have no plans to budget on an accrual basis, (although to ensure consistency in ex ante and ex post decision making this move is arguably required). In sum, due to the lack of a standard model, and the evolving nature of present arrangements, the practical implementation and sequencing of this budgeting approach is still a story in the making.

99. **The difficulties in moving to this final stage are easily appreciated**. There are major additions to the information required to accrual budget:

- the information that is included in the cash budgets currently prepared, viz., movements in cash and cash equivalents, the cash being spent on purchase of assets and received for sale of assets, and estimated financing transactions;
- estimated movements in inventories, receivables, payables, employee entitlements, and other liabilities; and
- details of asset depreciation, maintenance, and provisioning policies.
- a projected balance sheet of assets/liabilities

100. **While there are undoubted advantages in accrual budgeting its difficulties impose countervailing costs**. Accrual budgets would show projected cash flow (as existing budgets), projected revenues, expenses, and operating result in the operating statement; and projected assets, liabilities, and equity in the statement of financial position. Certainly, if achievable it allows the production of economic indicators that are extremely useful for fiscal analysis and decision-making. Moreover, if a government is able to achieve accrual budgeting, it should also have the capacity to carry out some form of accrual monitoring for the whole government, i.e., monitoring the real revenues and expenses and the movements in all assets and liabilities and not just cash. Having this capacity would seem a logical development of an advanced performance-based PFM system (see Chapter VII). The fact that so few countries with an already well-developed PFM performance orientation have fully reached this goal indicates how difficult it is to attain.

[56] See Blondal, 2003.
[57] Although apart from central governments, often state and local governments often budget on an accrual basis.

Meeting international reporting standards

101. **It should be recognized that accounting systems perform two central functions.** The first is the need to account for the financial position of the government at a particular point in time, (usually determined by legal requirements), to meet the objective of ensuring proper accountability for public funds. The second, involves the day-to-day recording of transactions, used as a basis for the information systems to aid PFM decision making. These management requirements usually necessitate more information than the legal financial statements, and on an on-going and timelier basis. Regardless of the system of accounting, whether it is cash or accruals, there is usually a need for budget managers to record each stage of the spending process and to be aware of other "off-balance-sheet" items such as contingent liabilities. Internationally, there have been recent attempts to lay down standards for governments in reporting on their budgets. In particular two standards, which have been embraced and promoted by development partners, are worthy of note and discussed below.

102. **Cash Basis International Public Sector Accounting Standards (IPSAS, cash), specify standards countries should meet when financial reporting against the budget under the cash basis of accounting**.[58] To comply with this reporting standard only cash can be included in the primary financial statements (Part 1), but it encourages other voluntary disclosures in the notes (Part 2), that could be non-cash. It is usual to recommend all of these disclosures to be detailed in the accounting policies of the country, which should be the first note, including such central issues as recognition and timing, and any areas that depart from either cash or accrual conventions. A main concern with the IPSAS Cash standard lies with its requirement for consolidation of government accounts at all levels and the consolidation of government cash accounts with those of parastatals under government control. This stringent requirement for consolidation is likely to prove difficult if not impossible for most LICs, hence this paper argues for a less ambitious accounting target, namely that the IPSAS Cash standard be applied to central government accounts, with consolidation of lower level governments if they have a significant share of general government spending (say, over 10 percent).

103. **The IMF's Government Finance Statistics Manual 2001 also sets standards for fiscal reporting.** The manual reoriented the IMF's previously prescribed cash basis fiscal reporting system to a format consistent with an accruals basis, harmonizing the GFS with other statistical systems—specifically the 1993 System **of** National Accounts and Balance of Payments (BOP) Manuals.[59] However, because GFSM 2001 is intended to serve a different purpose from SNA, the ways in which the data are recommended to be reported, and most of the balancing items, are different from the SNA. While GFSM 2001 focuses on the general government, it also recognizes the usefulness of expanding the coverage of fiscal data to the public sector. An important output of the GFSM 2001 is that it allows the generation of different key fiscal indicators part from the cash deficit: net and gross operating balance,

[58] Cash Basis IPSAS, issued January 2003, and subsequently updated, 2006, 2007, 2009.

[59] An exception being ESA 95 used for the European Stability and Growth Pact.

overall fiscal balance, overall primary balance, net financial worth, net and gross debt. All of which are useful for fiscal policy analysis.

104. **Improved fiscal reporting requirements, such as those implied by the GFSM 2001 standards, cannot be divorced from the parallel reform of the accounting system, which underlies the generation of the basic data**. It is possible from a statistical reporting standpoint to view the accrual-based GFSM 2001 reporting requirements as distinct from accounting requirements. If full GFSM 2001 reports are to be generated within year, and if these reports are to be useful for budget management as distinct from purely statistical purposes, full compliance with GFSM 2001 will require a supporting move to accrual accounting. Recognizing this, as an interim measure the IMF's Department of Statistics has offered practical solutions for countries with cash-basis accounting systems to produce summary reports consistent with the GFSM 2001 standards.[60]

105. **GFSM 2001 is also consistent with the standards of accrual accounting set out in generally accepted accounting principles** (GAAP). These have been specified in various IPSASs, which continue to be developed. Three aspects of these accrual standards should be noted. First, all such standards (IPSAS, GFSM 2001) require cash flow statements to be produced as part of their standards. Second, the strict application of these standards to ex post financial reports is not an absolute requirement, since the GAAP requires accounts to also meet other criteria, such as comparability, relevance, reliability and understandability. There may, therefore, be practical trade-offs in the strict applicability of accrual standards and these other dimensions.[61] Third, accruals will not provide all the information required for PFM decisions. For example, while accrual accounting offers far greater perspective on sustainability issues through the production of a government balance sheet, this should be supplemented with other longer-term information.

106. **The difficulties in meeting these standards should not be under-estimated.** For most LICs to meet these two international reporting standards, (IPSAS cash and GFSM 2001), usually requires extensive revisions to their accounting procedures and COAs. To produce financial statements in accordance with the cash-based IPSAS, typically is not straightforward, even for those countries with a well functioning cash basis accounting system. Usually there are several areas where a country’s approach departs from the IPSAS strict cash basis, such as netting of transactions, or only reporting on central government, or if reporting on the general government, not including reporting from government autonomous agencies or SOEs, etc.

107. **Often other fundamental reforms are required to meet these standards.** Apart from identifying these deviations and offering corrections, the experience of countries that

[60] The stage-wise move to satisfy GFSM 2001 standards is described in Diamond, 2006, pp.70ff.

[61] See IPSAS 1, Presentation of Financial Statements. For example, a usual exemption is in the accounting for tax revenues which are often uncertain, hence a full accrual approach may be deemed unreliable, and a modified accrual concept might be considered more reliable.

have embraced these IPSAS cash standards also indicates the considerable effort involved in their implementation. For example, often it is necessary to review the legislation to ensure IPSAS can be readily implemented for the financial statements; a report template needs to be developed which includes all the primary statements and notes to the statements (and agreed with the external auditor); a schedule/checklist of the sources of data for the statements must be prepared; where primary accounting data must be further analyzed (or managed outside the FMIS), auditable accounts must be prepared (on a format needing the concurrence of the external auditor); and then a timetable agreed that can be used each year for collection of financial information to prepare the statements no later than the statutory deadline. Similarly, for reporting on the fiscal balance using GFSM 2001 and adopting a functional classification in line with the Classification of the Functions of Government (CoFoG), also entails considerable work: complete mapping of existing object codes to GFSM 2001 and CoFoG; correcting any alignment issues and re-coding objects; as well as undertaking reviews of other coding segments such as organization, programs etc.; then issuing a new COA code book and training budget officers in its use.

108. **Countries should be expected to meet these standards before advancing their PFM systems.** Notwithstanding the substantial effort that may be involved, the production of financial reports compliant with these international standards should be considered a benchmark output for a successfully functioning FMIS and hence an indicator of the extent to which countries' PFM systems have reached a satisfactory level of financial compliance, albeit on a cash basis of accounting. The ability to do so should be considered a pre-condition for moving on to other more advanced reforms.

The Legal Framework for PFM Reform

109. **In terms of sequencing, it is an open question whether enabling legislation should lead or follow PFM reforms.** Much depends on the country's legal tradition: some countries define their laws to restrict powers, concentrating on what is not allowed, while other countries define their laws to grant powers, concentrating on what is allowed[62]. The difference in approach has major implications on the relative powers of the legislative and executive branches. In the first case, where the executive branch tends to be powerful, budget reforms can be introduced by regulation or amendment without introducing new legislation. Hence in countries following the Westminster model, fundamental budget reforms have been introduced and once proven useful have then been endorsed by changes in the law. Where the legislative branch is more powerful, as in many continental European countries, fundamental reforms are not possible without first introducing changes in the law. Apart from the question of whether new budget legislation is initially required, it is clear that some changes in content will eventually be required when the PFM focus is changed from enforcing financial compliance to accommodate higher level reforms.

[62] See discussion and description of various traditions in Lienert and Jung, 2005.

The legal basis to reach core PFM requirements

110. **A checklist of core legal requirements needs to be agreed.** As Tommasi has pointed out, the PEFA assessment framework does not specify "core" requirements for the legal framework governing PFM. Helpfully he provides a checklist of provisions that should be included to reach basic PFM compliance objectives, summarized in Box 4.4 below.

Box 4.4. Required Provisions in the Legal Framework to Meet "Basic" PFM requirements

- Timely submission of the budget to Parliament
- Ensure comprehensiveness of the budget, e.g., limiting extra-budgetary funds
- Specify enhanced data presentation in the budget documents
- An appropriation management rule that limits the freedom of the executive to make shifts between appropriations, without parliamentary approval
- Specify the authority to contract loans and grant guarantees, and the procedures for submitting these to parliament for approval
- Prohibition of the executive branch to initiate unbudgeted expenditures in the course of budget execution, except through supplementary appropriations
- Specify financial and fiscal reporting requirements
- Timely submission of the end-of-year accounts
- Independence of the external auditor
- Transparent and rules-based systems for intergovernmental financial relationships.

Source: Tommasi, 2011, Table 1.

111. **To this checklist for "core" legislative requirements could be added**:

- The power to open government bank accounts should be vested solely with the Minister of Finance or his delegated official.
- Appropriations should be "gross" so that expenditures should not be offset against revenues
- Specify rules for carry-over of budget authority at end of fiscal year, (usually requiring all to be re-appropriated although there may be some flexibility for investment spending).
- Contingency and reserve provisions should be limited with clear rules for the use of such funds.
- Limitations on the legislature's powers to change the executive draft budget.
- Prevention of the legislature from revising revenue projections upwards in order to accommodate more expenditure.
- Specify the date by which the budget should be adopted by the legislature and procedures if this is not met.
- Specify extent of the minister of finance's authority to cut appropriations, and the conditions under which this is permitted.

112. **Apart from ensuring core regulatory provisions are in place, there may also be a need to "clean up" existing legislation and financial regulations before moving to further reform**. In centralized traditional budget systems it is not uncommon to find an overly detailed layered system of controls that has accumulated over the years. Typically a set of controls is introduced to remedy some abuse. These controls are later circumvented, leading to the introduction of additional or more detailed controls to plug the gaps. The additional layers of controls further encourage budget participants to find ways to circumvent them to get things done, leading to a vicious cycle. Additionally, it is usual find that a large part of these controls are irrelevant, being derived from previous manual systems which have subsequently been replaced by computerized systems. Thus there is usually considerable scope for streamlining the regulatory system and ridding it of redundant and counterproductive controls. This streamlining of existing budget procedures will be essential for moving on to higher level PFM reforms that require adopting a more decentralized budget management style. However, before this is contemplated it must be confirmed that the existing regulatory framework is being enforced, with an effective system of sanctions in place.[63]

Legal requirements to support reforms beyond the core

113. **To accommodate the introduction of a MTBF it is usually necessary to make changes in budget preparation procedures.** Many countries have found it useful to adopt a two-stage process in budget preparation. The first stage would take the target macro fiscal framework, set government priorities within these targets, and evaluate new initiatives on that basis. This would be subject to explicit agreement by Cabinet. In the second stage the ceilings for each MDA would then be established—in two components— for current activities and for the new initiatives that represent new policies. The budget call circular would be sent out on this basis. Another change usually required for budget preparation is to lengthen the budget timetable to accommodate the construction of medium-term estimates and to allow for this two-stage preparation process.

114. **There are some additional elements of budget approval that perhaps should be included into budget legislation**. The first concerns the procedure for the legislature's approval of the MTBF. Some countries have adopted a legal requirement that the legislature must formally approve—as part of a two-part budget approval process—an annually-updated multi-year budget framework. The expenditure aggregates (and key sub-aggregates) for a three-year period are then legally-binding. In most advanced countries, the forward estimates are regarded as indicative rather than mandatory. The executive establishes quantified medium-term fiscal targets for debt, fiscal balances, revenues and expenditures, and based on this forward estimates are presented for information as part of the budget documentation, but are not formally approved. At the same time the executive would be required to submit to the legislature its medium-term fiscal strategy, its priorities for spending, and policies to achieve targeted medium-term aggregates for revenues, expenditures, fiscal balance and government

[63] A point stressed by Tommasi, 2011, Table 1

(or public) debt. The latter targets would be specified for at least two years beyond the next fiscal year, with clear identification of any new policies being introduced in the annual budget and their future impact.

115. **Introducing medium-term budget planning brings to the fore the issue of how to treat fiscal policy in budget legislation, since in traditional budget systems such legislation typically only focuses on systemic and procedural issues**. In recent years much attention has been given to fiscal responsibility legislation, which introduces fiscal rules to guide fiscal policy over the medium-term by imposing legal limits on fiscal aggregates such as debt levels, fiscal balances, revenues and expenditures, usually with sanctions for non-compliance. There is no best practice in this approach and it certainly should not be regarded as a legal requirement for introducing and successfully operating a MTBF. The experience with this type of legislation is quite mixed and clearly there are both advantages and disadvantages in the imposition of such rules[64]. If well designed and enforced they can provide valuable fiscal discipline and provide an important tool to achieve macroeconomic stability and sustainability objectives. However, fiscal rules require a high degree of political maturity to be accepted and relatively sophisticated institutional practices to ensure they can be enforced. There are examples of poor design leading to poor fiscal outcomes and perverse incentives for budget managers.[65] While adopting of the fiscal rule may have a positive demonstration effect, especially on the government's creditors, breaking the fiscal rule may have an even larger negative impact. On balance, it is probably best that countries first establish their capacity in medium-term budget planning, with an adequate track record of prudent fiscal management, before adopting such legislation.

116. **To accommodate the introduction of performance budgeting, there will be a need to revise the budget classification to be used in annual appropriation act(s)**. Typically, compliance-oriented budget systems include many detailed budget line items along with the institutional heads, each of which is approved by the legislature. Modern budget systems' typically have re-specified appropriations—usually as broad-based "programs" or "outputs". Of course, in such systems, the executive's financial regulations specify the degree that program expenditures need to be disaggregated for the purposes of expenditure control. Normally this implies the degree of flexibility delegated to the executive for implementing the budget is increased, and the budget legislation would also specify the Minister of Finance's virement powers (e.g., the percentage by which particular expenditures, typically classed by programs, can be re-allocated or exceeded without submitting a supplementary budget to the legislature). At the same time, countries that have adopted a performance-, or results-,oriented budget system usually have some legal

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[64] While the use of fiscal rules has gained some popularity in recent years, the concept is not new (e.g., the "golden rule"). It should perhaps be noted that in November 2005, the IMF Executive Board noted that, while numerical rules have some potential advantages, including helping to contain a deficit bias and addressing time inconsistency issues, they often lack flexibility, and have faced implementation problems in some cases.

[65] See G. Kopits, "Fiscal Rules: Useful Policy Framework or Unnecessary Ornament?", IMF Working Paper No. 1/145 October 2001.

requirement that annual (summary) performance reports be prepared by each major program or for each ministry, with the reports for year (-1) available in time of the legislature's consideration of the budget for year (+1).

C. Chapter V: Step Three: Move from Annual to Medium-Term Budget Planning

Summary: *This chapter focuses on how to sequence reforms required to better achieve longer-run PFM objectives, those of macroeconomic stabilization and fiscal sustainability. It is argued this necessitates a move away from annual to multi-year budget planning. The sequence is described as a phased move: to first introduce a multi-year fiscal framework, evolving this to a more detailed budget framework, and then putting this budget framework onto a programmatic basis. The latter, combined with a performance regime, allows medium term planning to also contribute to efficiency and effectiveness in resource decisions, a further stage of PFM development. The chapter stresses the variety of country experience, as well as the different ways these medium term plans are employed: for example, merely to inform, forecast, and analyze (medium term "outlooks") or as a budget decision tool and enforcement mechanism (a "framework").*

Introduction: The Need for Medium-Term Planning

117. **While traditional budget systems budgets are usually planned on an annual basis to better achieve macroeconomic stability it is necessary to move to medium-term budget planning**. To summarize previous chapters, the argument was made for a top level sequencing in PFM reform that gave first priority to the objective of financial compliance and fiscal discipline, and then secondly to the objective of macroeconomic stabilization and sustainability. To attain this second objective, it was argued, required moving from an annual to a medium-term budget planning framework. At the same time it was stressed that core requirements to ensure fiscal discipline on an annual budget basis should be in place before moving to multi-year frameworks.[66]

118. **Annual budget planning has recognized limitations.** While fiscal discipline is possible and desirable when budgeting on an annual basis, in the sense of delivering the budget close to that planned, it is generally recognized that the gains from such fiscal discipline are limited by the "annuality" of the exercise. It is possible to attain the planned annual budget revenues and expenditures but still end up with a deficit which is unsuited to prevailing macroeconomic conditions, or takes fiscal aggregates onto an unsustainable path that is likely to add to future macroeconomic imbalances.[67] This arises not only by the failure to anticipate future macroeconomic developments and their impact on fiscal aggregates, but also the failure to appreciate how present budget decisions impact future budgets. The latter

[66] As Castro and Dorotinsky put it, this is a tool which " like other budget tools does not replace existing procedures, but modifies and adds to them", p.2.

[67] The reverse is also the case: if fiscal developments are unsustainable correction will almost certainly have to take place over a period of time.

failure can arise from a number of sources, among them: not adequately accounting for the future costs of the current year's policy changes that typically will take more than one year to implement; the link between present capital expenditures and their future recurrent costs; the funding needs of entitlement programs that change even though policy does not; and the impact of contingencies.[68]

119. **To some extent many of the problems arising from annual planning would be eased by adopting an accrual based accounting system.** Such a system would give a better picture of the future resource implications of present economic decisions, accommodating inter-year problems such as carryovers and arrears. Moreover, since government balance sheets would need to be prepared, this would require greater attention to be paid not only to identify all assets and liabilities, but to consistently revalue and report on them. This, along with the need to specify depreciation, maintenance and provisioning policies, would provide an incentive for their longer term planning. Accruals would also allow more sophisticated measure of fiscal position than simple cash surplus or deficit to guide fiscal policy. For example, accrual based accounts would give the possibility of supplementing the typical cash surplus/deficit measures with such GFSM 2001 indicators as operating balance (net and gross), net financial worth, and overall fiscal balance. In this context it should be noted that GFSM 2001 recommends the net operating balance as a summary measure of the ongoing sustainability of government operations. However, there are some major items with longer-run resource implications that are not typically recognized as accruals, (the omission of liabilities such as old age pensions and health care entitlements) that should be part of longer-run sustainability decisions. As a consequence supplementary information would be required. Indeed, regardless of accounting system, there is a case for medium-term plans, albeit those based on accrual accounts will be more comprehensive and offer greater guidance in policy making. Having accrual basis accounting, does not vitiate the need for medium term budget planning but does allow it to be more sophisticated and comprehensive.

120. **For the majority of countries with cash based systems, the need for medium term planning is not in doubt.** It has been recognized that to attain stabilization and sustainability objectives along with fiscal discipline, it is necessary to try and accommodate the future impact of present resource decisions and plan cash budgets in a multi-year setting. While the medium term approach to budget planning has taken different forms in different countries, it is possible to map out a development path for such reforms that allows increasingly sophisticated procedures to be put in place to attain macro stability and sustainability objectives. In describing this development path, and hence a possible sequence for these reforms, this paper largely follows previous contributions in this field, specifically

[68] For a fuller description of these influences see Schiavo-Campo,2008, p.8.

(Castro and Dorotinsky, 2008, Schiavo-Campo and Tommasi, 1999, Oxford Policy Management, 2000, and Schiavo-Campo, 2008).[69]

Preconditions for Moving from Annual to Medium-Term Budget Planning

121. **Any move to medium term budgeting will have very limited value unless it is based on sound annual budgeting.** This implies that any problems in annual budgeting need to be addressed as a first priority. Specifically, the annual budget must be judged "credible" for a MTBF to have value. Credibility of the annual budget is addressed through PEFA performance indicators 1-4 that provide an assessment of whether the annual budget process is sufficiently sound in this respect. Revenue forecasting must be sufficiently accurate to provide a reliable basis for expenditure plans. MDAs should be able to rely on the annual budget as a firm guide to the funds they will actually receive. Realized MDA spending should be close to the spending approved in the original budget without large changes either through virements between heads or through large supplementary budgets. There should be minimal differences in budget and actual spending for the major categories of recurrent spending and for major capital projects. Arrears should be eliminated and not rolled into **the next year to be funded from appropriations intended for other uses.**

122. **It should be noted that this position although in broad agreement with, is perhaps is not perfectly aligned with Tommasi's view of the "core"**. In his determination of what constitutes core functions, he distinguishes between the "compliance budget" implemented in conformity with regulations, fulfilling desired fiscal control, and a "credible budget", which while allowing fiscal control also, needs to be placed in a realistic economic context to ensure its objectives are realistic. For him both compliance and credible budgets lie within the core level of PFM, implying the MOF should have some capacity in macroeconomic analysis place as to achieve this. However, a distinction should be made between the core level of macroeconomic analytical capacity and that required for medium-term budget planning, the focus of this section. Specifically, to move to medium-term budget planning requires two important PFM functions as preconditions: the ability to accurately forecast fiscal aggregates, and based on this, the construction of a guiding macroeconomic framework in which to prepare the budget. These are two features that Tommasi singles out as part of core functionality, and are required for ensuring an annual budget is realistic: a sufficient level of forecasting capacity and a realistic macroeconomic framework in which to integrate budget plan.

123. **A sufficient level of forecasting capacity entails being able to**:

- forecast revenue with some accuracy at least one year ahead;
- accurately forecast donor commitments that will be realized within the year;

[69] A recent survey paper by the World Bank, produced concurrently with this paper, Review of Experience with Medium Term Expenditure Frameworks", IBRD, 2011, although using different terminology also adopts the same sequencing for this reform.

- predict recurrent and capital expenditures at least a year ahead in an integrated way, (successfully estimating the carry-over of longer-run investment projects at year end);
- estimate the stock of arrears at year's end, and any outstanding commitments presently not due for payment that will fall due in the following year;
- estimate the revenues and expenditures arising from extra-budgetary activities;
- monitor the larger public sector, and estimate any likely resource demands that will arise in the future budget period from this source.

124. **In turn, this forecasting ability subsumes some important PFM functions are adequately operating**. Taking each of the above points in turn, the assumption is:

- There is a sufficiently timely and detailed monitoring of all revenues, and a sufficiently robust methodology exists to analyze any changes in the tax base and also allow for any foreseen macroeconomic developments and changes in policy.
- There exists adequate monitoring of foreign assistance and sufficient cooperation with donors to be able to predict the speed at which various disbursements will be made from different sources, including the correct timing of re-imbursements for expenditures already made.
- Although the recurrent and capital budgets may be prepared by different institutions, there is sufficient integration in budget preparation so that the recurrent costs of capital projects are adequately captured, and the extent of any delays in project implementation are known and can be estimated in terms of expenditure shortfall.
- The ability exists to estimate arrears correctly, assumes some form of commitment control, an accounting system that can record differences between commitments made and those that have been executed, and a timely and accurate reporting system that enables arrears and outstanding commitments to be aggregated across government.
- The MOF has the ability to monitor and assess the financial developments of any extra budgetary funds and the operations of other delegated entities in a comprehensive and timely manner.
- The MOF is able to monitor developments in the public sector on an on-going manner and is able to assess the fiscal risks arising from this source, so that it does not rely only on untimely final accounts of public entities when these problems become visible and is not surprised by guarantees falling due.

125. **There should be a macroeconomic framework on which to base the annual budget.** The MOF should have the capability of presenting alongside the annual budget a comprehensive fiscal strategy statement that underpins the macro **assumptions** guiding the annual budget. This should set the overall ceiling for government expenditure, outlining the assumptions with regard to viable levels for revenue, debt, deficit, expenditure and the government's approach to managing fiscal risks. In turn, this requires:

- The ability to use appropriate information and processes to produce timely forecasts of the main macroeconomic aggregates, with clearly stated assumptions about what is expected in the forthcoming budget year
- On the basis of the macroeconomic framework have sufficient information and an established methodology to forecast the main fiscal aggregates. In carrying this out, forecasts should reflect any significant policy changes that the government will be putting in place during the fiscal year, and their implications should be clearly identified for all major spending agencies.
- This forecast of fiscal developments is used to determine the overall expenditure ceiling for the government as a whole, and to consistently disaggregate this ceiling between the main spending agencies. On this basis the Budget Call circular should specify firm ceilings for all budget submissions. Within the circular there should be a clear statement on the macroeconomic parameters that are to be used for costing purposes, as well as the assumed implementation rates of major investment projects, and a corresponding ceiling projected separately for the capital budget.
- An assessment of fiscal risks and projected provision for risks should be an integral part of the government's fiscal strategy statement and reflected in the annual budget. Analysis of current and projected fiscal risks should cover:

  (i) Exogenous shocks. Expected fiscal outcomes may not be achieved due to a number of factors: slowdown in economic activity, exchange rate depreciation, interest rate shocks, terms of trade shocks, natural disasters, etc.
  (ii) Explicit contingent liabilities. If called upon explicit government guarantees (including financing of public-private partnerships) will have an immediate budgetary impact.
  (iii) Implicit contingent liabilities. For example, protection of depositors during banking crises, rescuing financially distressed subnational governments or state-owned enterprises (SOEs), and any potential legal claims (e.g., compensation of lost property) can impact the budget.

126. **Based on this foundation of firm fiscal control over the annual budget, countries should be able to proceed, over a period of time, to constructing a medium-term budget framework**. It is suggested that this reform be sequenced to allow the **development** of the necessary skills as well as to accommodate required parallel changes in budget processes[70]. The sequence of development is summarized in Box 5.1 below:

[70] Castro and Dorotinsky emphasize that implementing a comprehensive MTBF should be a gradual process, built in a sequenced way. They see three main steps in this process. This paper largely follows their path but recognizes some intermediate steps, some parts of which are elaborated in Schiavo-Campo, 2008.

Box 5.1. Phased Development of Medium-Term Budget Planning

►***Preparatory phase: improve analytical capacity***
● Strengthen forecasting capacity, to accurately forecast fiscal aggregates beyond the immediate budget year;
● Construct a macroeconomic framework for the annual budget, to set realistic overall ceilings in the forward years.

►***Prepare a medium term fiscal outlook (MTFO)***
Extend forecasting period, (say, the budget year and two forward years), to present projections of macroeconomic aggregates and current fiscal policy implications, to inform budget discussions.

► ***Evolve fiscal outlook to a medium-term fiscal framework (MTFF)***
MTFF becomes the basis for Cabinet decisions on fiscal aggregates and formal agreement on major policy initiatives. This should be accompanied by a statement of fiscal risks.

►***Add a medium term budget outlook (MTBO) to the MTFF***
Break down fiscal aggregates to main budget heads and line items, showing projected current budget policy, and any possible changes in policy, but for information purposes only.

► ***The MTBO would evolve into a medium-term budget framework (MTBF)***
Budget projections change from an information to a decision-making tool, so next year's estimates have some policy status. Concurrent changes are made in budget formulation processes to agree medium term budget priorities.

►***The MTBF is put on a programmatic basis, and its expenditure component becomes a Medium Term Expenditure Framework (MTEF)***
The MTBF is now strictly linked to policy and sectoral MTEFs, on a more detailed level, with full integration of recurrent and investment costs of programs projected in the out years. The fiscal strategy may also include non-financial performance ("results based") information linked to program budgets. Often the MTEF is associated with a more decentralized budget management regime, relying heavily on agency capacity to prepare forward estimates.

Stylized Development Path for Medium-Term Budget Planning

127. **The sequenced introduction of medium-term budget planning can be divided into five phases.** Conceptually, as summarized in Box 5.1 it is possible to identify five **main** phases in a sequenced move to comprehensive medium term budget planning:

128. **Phase 1. Commence with a medium-term fiscal outlook**:

- Establish a methodology for projecting macroeconomic aggregates and the corresponding broad fiscal aggregates, say for coming fiscal year and two forward years.
- These top-down projections of fiscal aggregates would most likely only cover the major categories of expenditure and taxes, non-tax revenues and grants, and not be presented in budget detail, i.e., will primarily be based on an economic classification.
- This outlook would inform budget discussions in Cabinet, and underlie the Minister of Finance's budget statement to the legislature.
- Within the fiscal aggregates there could be a clear identification of the cost of new policy initiatives and a statement of the government's main policy priorities in the

coming years. However, the principal objective of the outlook is to project the fiscal consequences *of present tax and expenditure policies.*

129. **This phase represents a logical move from the annual forecasting of macroeconomic and corresponding fiscal aggregates by extending the forecasting period**.[71]It is logical because to pursue macroeconomic stabilization objectives it is important to have a perspective that covers more than one year to accommodate the usual cyclical variations in macroeconomic activity. Apart from this technical aspect, the fiscal outlook should also include procedures to involve Cabinet and Parliament so they come to view the budget as more than an annual exercise by spelling out the longer-term repercussions of the current year's budget decisions. However, to do this successfully will require some degree of macroeconomic stability, as well as sufficient political stability so that politicians are willing to consider budgetary developments other than those that are extremely short-run.

130. **Phase 2. Evolve the fiscal outlook to a formalized medium term fiscal framework (MTFF). This should have the following features**:

- Rather than mere projections of fiscal aggregates, the MTFF involves cabinet decisions on fiscal aggregates, formal agreement on major policy initiatives, with more focus on the implied costs of new policy. That is, the medium term forecasting exercise becomes a framework for taking macro fiscal policy decisions.
- Due to its more formal status, the framework would be made public and should contain previous fiscal year data, and expected outturn for the current fiscal year for comparative purposes. This MTFF would be up-dated each year on a rolling basis—with explanation of major changes in the up-dates--and form an important input to the discussion of fiscal strategy and budget ceilings in the forthcoming year.
- Ideally this would be debated prior to annual budget formulation, and then up-dated nearer the end of the current year and presented with the proposed annual budget.
- The MTFF should be accompanied by a "statement of fiscal risks" that would include: (i) a discussion of past experience with materialized risks, (ii) policies to mitigate and manage risks, and (iii) forward-looking risk estimates. In addition to sensitivity analysis with respect to different macroeconomic conditions, an assessment of other potential risks such as the call-in of guarantees could be conducted using alternative scenarios and various assumptions on risk materialization.
- The budget should include some level of appropriation to cater for potential costs associated with possible realization of guarantees and contingent liabilities. The fiscal risks statement should provide a strategy for how the government will react to these possibilities.

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[71] This appears the level that Tommasi would define within his view of "basic" OPFM requirements.

- At a later stage, when the MTFF becomes more routine and the necessary skills acquired, a debt sustainability analysis should be added to the fiscal risk component of the MTFF.

131. **The move to a formal MTFF involves substantial deepening both of the technical expertise in the MOF as well as in politicians' ability to comprehend and their willingness to make decisions on this information**. This most probably implies that the MOF has a dedicated and stable team, (say, a macroeconomic policy analysis unit), that can perform the necessary macroeconomic analysis and has the institutional means to monitor, cooperate with, and coordinate inputs from other important institutions, such **as** the central bank, other ministries and the donors. As a framework for taking decisions, there should also be mechanisms to allow policy debate and revision, and the MTFF should be accorded some status as an official document and be open to public scrutiny. However, as a fiscal framework, any debate would be contained within broad economic aggregates, their relative growth to GDP, and the aggregate impact of new policies. These aggregates would not be translated into detailed budgetary aggregates, so that the MTFF would allow policy decision only at a very high level, but would represent a useful first step in the direction of more sophisticated medium term budget planning.[72]

132. **Phase 3. A medium term budget outlook (MTBO) should be added to the MTFF**.

- This involves breaking down the fiscal aggregates contained in the MTFF, typically presented on an economic classification, into the various heads and main line items found in the budget document.[73]
- Again a distinction should be made between the budget projections based on no policy change, and a clear identification of the extra costs expected from new policy initiatives. The outlook would focus on the baseline: projecting the implications of this year's policy changes, but not include any new policy initiatives in future years.
- This MTBO could be considered a background paper or presented along with the annual budget for information purposes, say as an annex.[74]
- This document would remain an outlook rather than a "framework" for decision making, since forward estimates of revenues and expenditures are regarded as projections of current policy and possible changes in policy but do not imply any decisions about budget resource ceilings in future years.

133. **The MTBO should be viewed as a useful preliminary stage before moving to a full MTBF.** As Schiavo-Campo and Tommasi, 1999, point out this phase serves as a

[72] The MTFF has been an integral part of the IMF's work for over three decades, so considerable expertise has been built up and also imparted to many countries that have had IMF programs.
[73] This can be done in stages. Schiavo-Campo, 2008, suggests that these aggregate estimates can then be made progressively more detailed. He suggests starting with the PIP and policy priority areas. (p.26 ff.)
[74] If quality cannot be assured it is best that the outlook should remain a working document, or internal document for information only.

projection of the baseline budget that can aid budget decision-makers, if for nothing else by emphasizing their limited margin for new spending initiatives. This phase also allows the development of the expertise within the MOF to translate broad fiscal aggregates into budgetary aggregates. However, to facilitate this move to budgetary estimation it may be necessary to make some institutional changes within the MOF.

134. **There is likely to be the need to fully integrate medium-term planning into more regular budget management operations.** While the macroeconomic analytical expertise may be concentrated within a specialized unit, budgetary expertise will be concentrated in the budget department of the MOF. It will be increasingly important to ensure integration between the preparation of the MTFF and the budget process, and it will be essential to avoid any separation between the two processes when moving from a MTBO to a MTBF. For this to be achieved it will most likely require the macro unit to be amalgamated into the budget office. Apart from the technical expertise required, and the way it is organized, there are considerable implications for political consensus mechanisms to be developed within Cabinet to handle the type of inter-ministerial conflicts that are likely to arise with this move. Specifically, there should be institutional mechanisms to handle the reconciliation between the top-down MTFF and the bottom-up ministerial budgetary demands and some Cabinet agreement on how "fiscal space" is to be handled in the outlook. It will also be necessary to ensure a mechanism whereby the budgetary outlook is recalibrated at budget time to accommodate any changes in the macroeconomic and fiscal outlook. As an outlook, any out-year estimates are unlikely to acquire much budgetary status, since essentially the outlook could be reworked every year. However, as preparation for the move to a full MTBF there should be a concerted effort to progressively improve the quality of out-year estimates in preparation for the time when they will assume some policy status.

135. **Phase 4. The Medium Term Budget Outlook would evolve into a MTBF. This would have the following features**:

- In the case of the MTBF, the nature of the medium term budget projections changes from that of an information tool to one of decision-making. The next year's forward estimate therefore is given some policy status in being expected to form the basis of the next year's budget estimates, so the next-year projections should be regarded as near budget quality.
- The MTBF reflects cabinet decision-making on aggregate and line ministry spending ceilings over the medium-term, and explicitly addresses decisions regarding medium-term cutbacks, the costs of new spending initiatives, the gains of new tax initiatives, and the scope of "fiscal space" left for new policies yet to be determined.

136. **Along with this change, there will be a change in the annual budget formulation decision process, to agree not just the next year's annual budget but the priorities that will shape future year's budgets**. This usually necessitates a change in the budget timetable, allowing more time for budget preparation.

137. **There are four preconditions for moving to a full MTBF.** These have already been mapped out in the discussion of the MTBO. First, and foremost there should be adequate technical capacity to forecast macroeconomic developments and fiscal aggregates **and** translate them into budget aggregates. Notably, the first out-year's budget estimates should be of near "budget quality" to enable them to form the basis of the next year's budget round and allow a smooth rollover between fiscal years. As indicated, this would be facilitated if the production of the MTBF is seen as an integral part of budget preparation by the Budget Office and not a separate exercise. Secondly, the strategic phase of budget preparation must be robust. An institutional structure and budget procedures should be in place to allow the Cabinet to endorse fiscal targets, and specifically to agree the aggregate and individual line ministries' expenditure ceilings over the medium-term. For this to be successful there should be clear rules over how "fiscal space" will be handled, and in particular explicit treatment of the level of any margins to be left for future contingencies and new policies yet to be identified. Thirdly, there should be adequate political commitment to decisions made over future resource use. This requires that parliament adequately debate the MTBF document, and that clear rules exist about parliamentary approval of the aggregate and sector ceilings contained in the MTBF. In addition, agreement needs to be explicit on the scope of the parliamentary vote and how any subsequent budget amendments are to respect those previously determined ceilings. An arrangement that countries have found useful is for the parliament to vote on the budget in two steps, first on the aggregate resource envelop and, when this is agreed, then on the detailed expenditure plans. Very few countries have, however, moved to multi-year appropriations. While budgets remain annual in their nature, they are nested in a medium-term framework, but that framework should not be viewed as a medium-term budget.[75]

138. **Typically budget procedures are fundamentally changed with the introduction of the MTBF.** In order to accommodate this extra layer of strategic decision-making, as well as the technical work required by multi-year budget estimates, most countries extend the budget preparation timetable. Also, given the amount of work involved in determining multi-year estimates and enforcing them in budget execution, it is useful if the number of line items is considerably contracted. This in any case should reflect a change in PFM priorities, from fiscal compliance as the dominant priority, which tends to focus on details, to include macroeconomic stabilization and sustainability objectives that tends to focus on aggregates. *Thus the fourth requirement is the changes in budget legislation and financial regulations that are required to support the MTBF processes,* (as previously discussed in Chapter IV).

139. **Phase 5. The expenditure component of the MTBF is put on a programmatic basis**.

[75] It is for this reason the term medium term budget planning has been used in this paper instead of medium-term budgeting. "Budgeting" can be an ambiguous term, often characterized as covering all the phases: preparation, presentation, approval and appropriation, while countries generally do not follow a uniform approach at all phases.

- This implies that the MTBF is more strictly linked to policy and is built up from sectoral MTEFs. The latter are founded on government-agreed sector policy, say as outlined in a sector strategy paper. Then all current and future programs supporting that policy are specifically identified in the estimates. The expenditure implications of these programs for the current budget year and for future years are then indicated, with clear differentiation between "old" and "new" policy initiatives, and the identification of the residual fiscal space.
- This turns the MTBF into a policy document with a strong alignment of any policy change with budget changes, both at the whole of the government level and for individual ministries and agencies. The MTBF should contain an explanation of the expenditure priorities and the rationale for these in terms of policy outcomes desired. Whereas the non-programmatic MTBF is a strongly top-down process, its programmatic equivalent must have a sound 'bottom-up" component implying considerable managerial skills at the line agency level.
- The explanation of spending programs is very detailed: expenditure intentions are related to the ceilings, presented by primary spending authority, (or groups of these), for proposed expenditure using suitable classifications, along with the estimated actual policy results for the year prior to forthcoming budget year, and forecast costs for forthcoming budget year and two or three succeeding years.
- This detail extends to the public investment program. Explanation should include priorities and their rationale, with investment spending related to the ceilings, presented not only by primary spending authority (or groups of these) but also by the programs of which they are a component part. This would also include the estimated actual results for the year prior to forthcoming budget year, and forecast costs for the forthcoming budget year and the two (or three) succeeding years;
- At a further stage of its development the fiscal strategy could include forecast non-financial performance information at a suitable level of aggregation linked to the budget to show what is planned to be provided and achieved for the proposed expenditure (i.e., include indicators of the outputs and outcomes expected).

140. **This programmatic MTBF, or MTEF, represents the highest level of medium-term budget planning**. It should be viewed as an element of a further stage in the evolution of PFM— where budgeting has been reoriented from the traditional focus on inputs (concerned with compliance) to a new focus on the results derived from these inputs (concerned with efficiency and effectiveness in resource use). This reorientation necessitates a critical change in budget management, away from traditional centralized control systems to more decentralized management models. The latter fundamentally alters the accountability relationships within government replacing detailed central controls with greater flexibility for budget managers operating at "arms length". This move, often termed "results based" or "performance budgeting", is associated with reforms to: first, allow managers greater flexibility in managing resources; secondly, to give them greater certainty in resourcing; and thirdly, to introduce a system of rewards and penalties to pressure managers to "perform" in

the sense of achieving the stated objectives of government policy. All such reforms are necessary preconditions for a successful programmatic MTBF. Viewed from this wider picture, the programmatic MTBF should be seen as only one component of a much larger reformed budgetary process, and a component that needs to follow not lead such reforms. Without the considerable and difficult changes in budget processes required to introduce this performance budgeting approach it is difficult to see the gains in introducing a medium term framework on a programmatic basis. Indeed, jumping to a programmatic MTBF without such a reformed budget system in place is likely to invite considerable dangers.[76]

Some clarifications and qualifications

141. **When presenting this stylized development path as a reform sequence a number of clarifications and qualifications are in order**:

- **The difference between an outlook and a framework.** This difference hinges on the degree of strategic decision making that is incorporated into the process of constructing a medium term framework. If the medium term exercise is designed for information, is primarily a forecasting device, or exists as an analytical consistency check on the fiscal aggregates, it remains an outlook. If, on the other hand, it incorporates all of these functions but is also a budget decision-making and decision-enforcing tool, it becomes a framework. In this interpretation a framework implies the Cabinet has decided on and endorsed the multi-year targets and expenditure ceilings, and also possibly the legislature. These targets and ceilings are integrated and enforced in budget preparation. This implies first, that allocative decisions have been made to reconcile the baseline budgets and major policy proposals with the ceilings. Secondly, that the forward estimates have some status as a baseline for future allocative decisions, so that the next forward year becomes the basis for budget discussions for that year's annual budge. Thirdly, the out-years are rolled over so that the present framework becomes the starting point for the next framework. In this way the framework is an institutional mechanism not only for setting multi-year budget objectives but also adhering to them when executing the budget. Without cabinet level decision-making and endorsement in budget formulation, approval and execution, medium term exercises remain technical exercises, undoubtedly useful but with limited impact on the budget.t
- **The difference between a MTBF and a MTEF.** This distinction at the simplest level is clear: a MTBF covers both sides of the budget, the medium term resources that are available as well as the way they are to be spent, whereas the MTEF focuses solely on the expenditure side. However, at a more fundamental level—and critical to the correct sequencing of PFM reforms—the difference hinges on the different objectives of medium-term budgeting. A MTBF clearly focuses on the bottom line,

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[76] This has been recognized by contributors in the field, for example, Castro and Dorotinsky and Schiavo-Campo and Tommasi, 1999, make a point of explicitly differentiating the medium term approach to budget planning from the fully fledged MTEF.

the viability and sustainability of a specific deficit, and by implication a specific debt level, i.e., it focuses on macroeconomic stabilization and sustainability issues. Given the obvious limitations of annual budgeting to ensure macroeconomic stability over the cycle, it is argued a medium-term approach will not only improve aggregate fiscal discipline, (e.g., by avoiding the inevitable rush to spend at the end of the fiscal year and fully take account of future resource implications of present policies), but give rise to more effective counter-cyclical fiscal policy (e.g., by taking into account likely future macroeconomic developments), and steer budgets to follow more sustainable long-term fiscal targets (by ensuring debt levels remain at safe financeable levels).

142. **An "MTEF", specifically one on a programmatic basis, is a detailed attempt to relate policies to expenditure over the medium-term, and is equally focused on the efficiency and effectiveness of sectoral resource allocation decisions**.[77] This position is clarified in (IBRD, 2011), where a MTEF is defined as integrating three components, a MTFF, a MTBF and a Medium Term Performance Framework (MTPF). The latter ensures technical efficiency by introducing a performance management regime (based on policy relevant programs).[78] In this way medium-term budget planning is also viewed as a means of resolving the perennial PFM problem of ensuring budgets support longer-term planning objectives and sectoral priorities. Planning the budget on a programmatic basis over the medium term, it is argued, will enhance strategic prioritization in resource allocation. The increased planning certainty that this is likely to bring to budget managers, as well as the increased transparency and accountability it brings to fiscal policy, is seen to contribute to improved expenditure efficiency and effectiveness.

143. **The MTEF should be differentiated from other stages.** Any of the five phases in developing medium term budgeting previously described in Box 5.5 should contribute progressively to the objective of macroeconomic stabilization and sustainability. However, only with the last phase, where a MTBF is constructed on a programmatic basis with a performance management regime, is it also likely to contribute significantly to increased

[77] Most commentators on this approach have stressed how overloaded the concept has become. For example, to Castro and Dorotinsky, "the MTEF is about enhancing annual budget processes through the adoption of fiscal targets, the addition of a medium term perspective, a more sequenced decision-making process, and other improvements brought about by organizing data by policies and programs". Castro and Dorotinsky, 2008, p. 2. Of course, in practice it is possible to set fiscal targets without a MTEF, it is possible to organize the budget by policies and programs without adopting a medium-term perspective, etc. However, the important concept for them is a "framework:" that makes the concept the sum of these processes, and perhaps at the same time makes it a daunting proposition. Thus the Oxford Management Policy group cast doubts on the legitimacy of its universal application, pointing to the need for stringent prior conditions to be fulfilled, conditions that are not easily met in LICs.

[78] Indeed, the study up front admits that "only a few countries have an MTPF and even for those countries little is known about program outcomes, making it difficult to make judgments about technical efficiency." (p.vi); significantly the paper contains a strong warning that "It is unlikely that countries that have difficulty managing annual budgets and lack some basic management features,.....will benefit from adopting a MTEF" p.18.

efficiency and effectiveness in resource allocation. As indicated previously, this last stage of MTBF development, the World Bank terms a "MTEF", assumes a most advanced PFM system. Certainly, efficiency and effectiveness do appear to be important objectives of this type of MTEF in the countries that have reached this most advanced level of medium-term planning.

144. **The distinction between a MTEF also arises from its focus on the expenditure side rather that a MTBF that encompasses both sides of the budget**. Of course, a MTEF, concentrating on the expenditure side, most likely reflects the greater scope in these advanced countries for raising the funds to meet desired expenditure policy objectives. Such a presumption would be dangerous for most LICs and even most middle income countries. Unfortunately, it is often found that international organizations promote this programmatic approach in LICs, with detailed MTEFs being constructed for different sectors, associated with the popular sector wide approach to development planning. Sometimes the argument is made that adopting this MTEF approach will force the introduction of more comprehensive reforms. However, by developing sector MTEF's before a suitable whole of government framework has been developed could imply placing efficiency and effectiveness before macroeconomic stability and sustainability, which should be questioned. Certainly, that approach runs counter to the high level sequencing in PFM objectives that is adopted in this paper.

145. **Countries vary greatly in their design of MTBFs**. It should be recognized that it is difficult to define the "ideal" MTBF from international experience since countries vary greatly in how they have designed their MTBFs. Even among the more advanced countries typically the coverage is less than 100%, with MTBFs often omitting social security or local government spending. The level of detail also varies widely: some focusing on sectors, others on ministries and departments, others on departments and their programs, still others on programs that span various departments or even wider "missions" that cover more than one ministry. While the time horizon of MTBFs appears to average between 3 and 4 years, countries vary greatly with respect to the frequency with which the MTBF is revised: typically every year, but sometimes every two years and in some cases even every four years. Also the "status" of the forward estimates varies considerably between countries: sometimes they are only judged to be indicative, sometimes more than one year is fixed in terms of appropriations, but generally the forward estimates remain just that, and are revised on a rolling basis. Due to this wide range of experience there is no one model for the design of an MTBF that can definitively claim to represent best practice.

146. **Countries vary greatly in their actual sequencing of medium-term budget reforms.** While a medium-term focus in budget planning is becoming ever more prevalent, it would be difficult to identify a country that has progressed in the exact sequence of the five stages outlined above. Some countries appear to have settled for a fiscal outlook and a MTFF rather than develop them further to a true MTBF. Certainly, there is value in fiscal and budgetary outlooks that provide information on the required development of fiscal aggregates

to match changing macroeconomic conditions. Others, convinced of the greater benefits of tying budget aggregates to changing macroeconomic conditions, have attempted to jump to a MTBF sometimes without a fully functioning MTFF. Even more hazardous, some countries have jumped, often with the assistance of donors, to a MTEF based on programs without achieving a MTBF based on economic categories of expenditure. This varied experience in introducing medium-term budgeting is reflected in its varied success across countries. The fact remains that apart from a handful of countries, few have succeeded in introducing a fully program-based comprehensive MTBF (or MTEF) as described in stage five.

147. **This low success rate with MTEFs is not difficult to explain.** Even based on an economic classification the MTBF faces considerable difficulties, among them: the need for a sufficient degree of macroeconomic stability, a political environment prepared to view budgetary developments beyond the short-term, institutional arrangements for integrating planning and budgeting, adequate enforcement mechanisms in budget execution to stick to budget ceilings and their roll-over to forward years, and the technical capacity required in fiscal and macroeconomic forecasting and modeling. To move to a programmatic basis further requires well constructed and agreed policy-based programs, integrated recurrent and capital expenditure costing of those programs, a clear accountability structure for the management of programs, with agreed targets in terms of their expected outputs and outcomes. It is not difficult to appreciate why few countries have reached this level of sophistication, and that why such a PFM level is likely to be out of the reach of most LICs.

148. **It should also be recognized that moving the MTBF to a programmatic basis considerably increases the risk level of the reform.** Each of the prior phases—fiscal outlooks, MTFFs, MTBOs, and non-programmatic MTBFs—progressively take more time to implement, but essentially remain reforms concentrated in the MOF and involve procedural rather than behavior changes. On the other hand, a programmatic MTBF considerably increases the scope of the reform and is de-concentrated, requiring procedural and behavior change throughout the budget system, i.e., has a high risk profile. It is perhaps not surprising that in the most recent literature that there has been some reconsideration of the wisdom of promoting this programmatic approach to medium term budget planning in developing countries.[79]

D. Chapter VI: Step Four: Program and Performance Budgeting

Summary: *This chapter describes the sequencing of reforms to attain greater efficiency and effectiveness in government operations, typically the final stage of PFM development. This is characterized as a phased move to construct more policy relevant programs, to use these programs to prepare and execute budgets, and finally to introduce in stages a performance management framework. It is argued that the latter changes will require a fundamental restructuring of the PFM system: further strengthening of ministries' financial management,*

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[79] See Le Houerou and Taliercio, 2002, and Brumby, 2008.

offering greater flexibility to managers, and providing adequate incentives for them to adopt this new management style.

The critical role of program-based PFM

149. **It is important to appreciate why achieving efficiency and effectiveness in service delivery is considered the third PFM high level deliverable**. It has been argued that the recommended sequence of top-level PFM priorities for a PFM reform program, regardless of the country under consideration, should be financial compliance, followed by macroeconomic stability and sustainability, and lastly, at the highest level, efficiency and effectiveness (Chapter II). Placing efficiency and effectiveness last in the top level deliverables does not imply that such objectives were somehow less important than the others, nor was it simply based on historical evidence of how most countries had progressed their PFM systems. Rather it was argued firstly that to fully meet efficiency and effectiveness objectives required that the other two objectives had been attained; and secondly, it was based on the recognition that countries had developed their PFM systems along this general path for sound reasons. Namely, to attain greater efficiency and effectiveness in government spending requires the introduction of a higher level of PFM skills and more complex PFM processes. These requirements arise from the nature of these objectives. To talk of pursuing efficiency requires some way of measuring outputs derived from spending and the means of comparing the cost of inputs to attain those outputs. To decide how outputs are to be defined, how they are to be measured, how they are to be tracked, and then how to relate them to the costs, is not easy in the government sector. To talk of effectiveness goes even further, in taking these outputs, however defined, and being able to relate them to the desired policy outcomes to which they are directed. This involves far more complex operations than those of traditional budget management.

150. **To successfully accomplish this refocusing of PFM towards outputs and outcomes requires a fundamental change to the way that budgets are managed**. A traditional budget system typically concentrates on the "correct" use of inputs—correct in the sense that inputs are purchased at least cost (i.e., are "economical") and are purchased according to the amounts authorized in the annual budget law, (including approved adjustments). The move to include efficiency and effectiveness in PFM objectives requires budgets to be set up with a clear understanding of the outputs that are expected to be derived for expenditures made and some, at least implicit, theory of how these outputs will generate desired policy outcomes. This is usually accomplished by moving the budget format away from its sole reliance on line items and onto a program basis.

151. **The concept of programs, well understood in advanced countries, has for a considerable time been promoted in developing countries**. Consequently its desirability will not be labored here.[80] Programs can be viewed as any suitable and integrated group of

[80] It is interesting to note that Allen Schick wrote a review of the development of the concept in a symposium on the subject as early as 1966, (Schick, 1966).

activities and projects, under a single manager, which consumes resources to contribute to a specified policy objective. In this way the operational objectives of each program and its constituent activities can be identified. Budgeting and accounting can then be carried out on this basis, so that the separate costs and revenues of each program/activity are made clear to decision makers. Having a single manager allows accountability to be more easily identified and enforced. Of course, this conceptual approach has been open to many interpretations in practice. [81] In some cases the interpretation of a “program” corresponds more closely to a broader concept of a function (e.g., health, education, etc), and in others it is closer to a line item of expenditure (e.g., public debt service). Moreover, because it is policy oriented, inevitably a program structure is country specific and should be designed to serve the needs of the policy makers. Even the idea of unified management of a program is felt too restrictive in certain countries.[82]

152. **While restructuring the budget on a program basis is generally seen as a move with much value added, also it should not be denied that its successful implementation has proved to be universally difficult, regardless of the country setting and the form attempted**. The difficulties have been well documented in the literature: difficulty in providing meaningful information on outputs and outcomes; even greater difficulties in assigning costs to individual outputs; suspicion of information overload; legislators' reluctance to yield detailed line-item controls associated with the concern that in doing so financial compliance will be compromised; and failure to implant this move into wider PFM reforms, particularly increased delegation in spending authority to the program managers. Not surprisingly for many countries a program structure remains just another way of classifying government spending, or alternatively, gives policy legitimacy to the organizational structure of government by simply aligning programs with budget institutions. However, if properly introduced constructing a program structure should involve some fundamental rethinking of government operations and their justification—a task, perhaps not surprisingly, that many government officials and politicians might be tempted to avoid.

153. **Even accepting these past implementation difficulties, placing the budget on a program basis should be seen as only the first, but crucial, step in pursuing efficiency and effectiveness objectives.** To successfully achieve these objectives requires the program structure incorporate at least four characteristics:

- **It should be set in a wider strategic framework.** Basically the program structure is a way of describing the expenditure plan of the government in terms of its objectives. To reflect this, the program structure should be anchored in a wider strategic view

[81] Also with many different names e.g., “output classes”, “requests for resources”, “business lines”, “key results areas”. Often a hierarchy in outcomes is incorporated into the program structure: high level outcomes are identified across sectors of government by key results areas, main policy areas, or high-level programs, with line ministry programs described as contributing towards these high level outcomes (see Robinson and van Eden, 2007,p.67).

[82] Only a few countries have attempted, usually selectively, inter-ministerial programs, e.g., Sweden and France.

that describes how government operations contribute to the achievement of nationwide objectives. As these objectives evolve and change in priority so should the program structure. Thus a precondition for the move to program-based budgeting is an understanding on the part of key policy makers and budget participants of the value of making the budget more policy relevant, making it less an instrument of control and more of one geared to achieving policy objectives. This represents something of a culture change, not least among those in the MOF's budget office who have often been found ambivalent to these reforms.

- **It should be defined to support political decision-making and prioritization.** Following from the need to relate programs to wider policy and planning priorities, it is necessary to make clear the relationship between the resources used by the program and the proposed outputs and/or policy results (outcomes). This implies that programs are provided with sufficient resources to meet the objectives assigned to them, and in turn, that there exist agreed rules for assigning these resources to specific programs so allowing a correct costing of each program's outputs. Thus a precondition for the successful design of programs is the existence of the necessary skills in line ministries to be able to reformulate their line-item budgets into meaningful programs, integrate both recurrent and capital components of the budget, and successfully assign these costs to program outputs. Often this is not straightforward: decisions require to be taken on how to allocate indirect costs that are common to outputs (e.g., overheads), or how to assign costs when some units of government provide intermediate inputs to other units, or how to treat government units that produce joint products, etc. Whatever the cost methodology adopted it is important to ensure it is cost effective: the expense of managing the costing system must not be onerous in terms of resources and staff time. An often ignored pre-requisite for a successful program based budgeting is the development within government of skills in cost accounting.
- **It should ensure accountability.** Programs and sub-programs should be disaggregated into activities and projects in such a way as to support clear managerial responsibility in attaining the proposed outputs and outcomes. This implies each program has an appropriate size for efficient management, and clear managerial responsibility throughout its sub-programs and activities, usually within a single organizational unit. It also implies that programs should be designed and "owned" by the organizational unit and not by the MOF or central budget office. One mechanism to ensure this is to clearly assign responsibility for implementing each program to an administrative unit which in turn has one chapter or "vote" in the budget. Where this is not possible it is important that there is a clear assignment of lead roles to a particular budget chapter.
- **It should be integrated into a wider performance-enforcing budget management model.** Gaining maximum benefit from the program structure, both in terms of improved performance and in terms of allowing accountability to be enforced, requires wider budget management reforms. It entails that performance information should be generated and reported to gauge how successfully program outputs are

attained and objectives are fulfilled. This should provide feedback not only to the managers responsible for implementing the program, but to central policy makers who have authorized the program's resources. This information should then be used to hold managers accountable for, and to address, any efficiency and effectiveness problems that emerge. This is essentially what "results based" or "performance" budgeting is designed to do.

154. **In meeting these four requirements, it is possible to view the move to ensuring efficiency and effectiveness in government spending as a two stage process**. Firstly, as a precondition, a policy relevant program structure needs to be introduced; and, secondly, this program structure must be used to measure the performance and enforce accountability of budget managers. It should be recognized that, if done properly, both stages of the reform should be introduced in a phased way that could take a considerable period of time. Moreover, it is a reform that is de-concentrated, involving all units of government, with considerable changes demanded in the behavior of all budget participants. These characteristics imply this reform has a high element of risk.

Phased Introduction of Program Budgeting

155. **Phase 1. Develop a more policy-relevant program budget classification.** The program approach to budgeting has been around a considerable period of time, during which most countries have experimented with the concept in some way or another. Some countries adopted a bottom-up approach, letting line ministries translate what they were doing into "programs". These typically ended up being institution-based, with the different organizational units of each ministry in charge of a "program", and often with program objectives described in terms of the activities subsumed in the program. This approach tended to leave the organizational structure of line ministries intact, hence was more acceptable to the ministries, but the resulting programs often lacked policy relevance. In contrast, other countries attempted a top-down approach, where the MOF attempted to disaggregate the main line items in the budget into different functions, perhaps using the UN's COFOG system, and then breaking the functions down into programs and sub-programs to be super-imposed on the ministry organizational structure. This approach, while trying to be more policy-relevant, tended to be much more disruptive to the line ministries and hence encountered the most resistance. Regardless of the approach and despite the existence of programs—however defined—for most countries programs failed to gain the prominence expected and the budget remained solidly input based, both in its formulation and execution.

156. **A lesson that has emerged from previous experiments in program budgeting is that the best approach is for the programs to be jointly determined by the MOF and the line ministries**. In this way the ministries have ownership of the programs and the MOF is assured of classifying budget activities into some way that is useful for top level allocative decision-making. Of course, a precondition for the latter is clarity over policy priorities. To link policy goals to government activities, the crucial idea behind programs, requires policy

goals to be articulated in some way, either through a broad strategic plan, a longer-term development plan, or at least some comprehensive political manifesto of the ruling party. Often, especially in LICs facing immediate fiscal problems associated with macroeconomic imbalances, this precondition is absent. Or alternatively, existing political manifestos, strategic plans and development plans although they exist, have been overtaken by macroeconomic events, or failed to accommodate new policy priorities, and hence lack realism. In such cases, without a stable policy anchor it is perhaps prudent that countries stick to traditional input budgeting and focus on the attainment of the first two PFM priorities: financial compliance and fiscal stability and sustainability.

157. **Phase 1. Ensure a number of preconditions are in place.** Only if there is a sufficient level of financial compliance and fiscal stability to provide a realistic policy base for the reform should countries attempt to introduce a program structure—or, more likely—to improve an existing program structure. Some of the key elements in this move are:

- The MOF should cooperate with ministries to better define programs within the ministry structure, breaking overly large programs into sub-programs and activities[83], and aligning their capital budgets, which often remain separated from the recurrent budget, within a common program structure. It is also important to ensure the various layers of the program structure—program, sub-program, activities, and projects—are logically related in meeting policy objectives.
- In this redefinition of programs, initially it is important not to be too ambitious and to align programs and sub-programs as much as possible with the ministry's organizational structure. In this way ownership and accountability are assured and institutional resistance minimized.
- To better define programs it will most probably be necessary to refine the policy objectives of the line ministries. This may require the development of better articulated and more realistic sector strategic plans, and within them to better define the program contributions of the line ministries in that sector.
- Progressively, there should be continued efforts by the MOF to work with the ministries to refine the organizational basis of their programs to avoid overlaps and gaps in responsibilities. However, too many changes to the organizational structure should be avoided.
- At the same time the better definition of the programs should lead to a more refined budget classification with improved consistency and a clear separation from the other classifications--line item (economic), organization, function, and funding classifications. At this stage the program classification remains purely a budget classification and not a component of the chart of accounts.

[83] In this way ensuring programs contribute both to facilitating centralized decisions regarding resource allocations between programs, as well as ease in managing programs within ministries.

158. **The amount of time to complete this work across government should not be underestimated.** A staged approach is recommended, first using pilots, and then progressively rolling out this work across all ministries. The Annex to this chapter gives some indication of the various components of the work required and a likely timeframe. The end result of this first phase is an improved program classification that can be used as a planning framework. Budget preparation and control would remain input based. The next stage will be to complete the necessary preconditions to use the program structure as the basis for budget management.

159. **Phase 2. Prepare the move from program classification to program budgeting.** In order for ministries to take programs more seriously and for the MOF to be comfortable with greater emphasis on program-based rather than line item controls, a number of prior conditions should be put in place:

- To ensure maximal contribution to allocative decision-making, as well as to avoid gaps in accountability, efforts should be made to make the coverage of the program structure as comprehensive as possible. This implies the inclusion not only of all regular budget expenditure, but special programs that may be administered through extra-budgetary funds or autonomous entities of government.
- The MOF should agree the costing methodology that lays out the rules on how costs are to be attributed to programs. It should then devise a training program to familiarize the MDAs with these rules. As indicated, one of the most difficult issues is how overheads or central administrative outlays are to be assigned to different programs.84 It is recommended that this initially be kept as simple as possible by creating a separate program for central policy and administration. Later, with the greater sophistication that comes with more experience, the costs of these support programs can be disaggregated and assigned to specific programs with a common objective.
- The MOF should have an FMIS that can track budget execution on a program basis. This usually requires the codes for the program classification to be included in the chart of accounts, and hence the FMIS software recoded to accommodate this change. Typically, the government accountant's office that sets the accounting rules for government must sign off on any such changes (perhaps with the endorsement of the external audit office).
- To offset the increased complexity that comes from including program codes in budget classifications, and in preparation for the greater emphasis to be placed on controlling by programs, the line item controls should be simplified. Typically, most countries operating traditional budget systems have overly-detailed budget line items and can easily simplify this classification by "broad-banding" them—grouping

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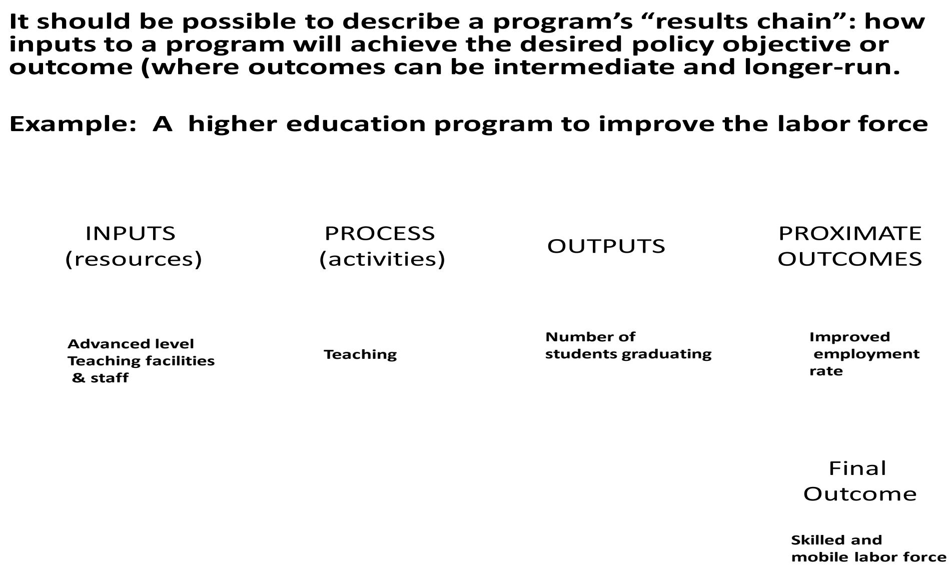
[84] These "administrative" or "corporate service" programs, describe activities that support the ministry in delivering services to external parties. These "are programs not focused on own outcomes, but supporting those of other programs" (Robinson and Van Eden, 2007, p. 69).

similar items together in an aggregate line item. Of course, any such change in the way that the budget is reported to parliament would most likely require the latter's endorsement of the change.

- To be comfortable with giving up this detailed line-item control the MOF should be satisfied that there is adequate capacity in the line ministries' internal controls and internal audit function to accommodate monitoring and controlling spending on a program basis. Typically this capacity is found wanting, since in the past the budget system has relied heavily on strong central controls that compensated for weaknesses in line ministry controls. Consequently, to introduce program controls often requires specific efforts to enhance ministry internal controls and audit.
- In anticipation of later moves to program-based management, it is useful for the MOF to agree with the line ministries on a small set of indicators for the performance of each of their programs. Initially these should be small in number and relatively easy to measure. They could be process indicators (indicating how well inputs are being used) or at most simple output indicators (indicating what the inputs have produced). All indicators should have the potential to be translated into easily understood targets. At first it is not recommended to be too ambitious, and certainly not to the extent of trying to measure policy impacts and outcomes (effectiveness indicators). The various types of indicators are illustrated in Box 6.1 that also offers the suggested sequence in their development: first defining inputs better, secondly measuring efficiency in internal processes, then moving to outputs and eventually to impacts. At the same time a format for, and the timing of, reports on these performance indicators should also be agreed.
- At first ministries should be encouraged to make their budget proposals on the basis both of line items and their programs. Increasingly emphasis should be laid on the program budget bids, encouraging ministries to include both recurrent and capital costs of programs. In association with the move to a programmatic MTEF, as discussed in Chapter V, ministries could also be asked to project ahead program costs for the next two or three years, moving them to make their forward estimates on a program basis. (The existence of this capacity within ministries, it will be remembered, was a requirement to reach the last and fifth phase of developing medium-term budgeting).

Box. 6.1. The Use of Performance Indicators



Indicators of Performance:

1. **Input indicator:** number of post doctoral staff recruited

Target: Recruit X number staff within a given time period at X$ cost

2. **Process indicator:** number of students per post doctoral staff

Target: Increase post doctoral staff/ student ratio by X% in each of next three years

3. **Output indicator**: number of graduating students

Target: Number of students graduating per student population increased by Z% each academic year

4. **Proximate outcome indicator:** number of graduating students employed

Target: Increase number of graduates employed within six months of graduating by Y%

5. **Final outcome**: increased productivity and labor force mobility

Target: Incomes of skilled labor increase to within W% of OECD average in next five years; job turnover of graduate employees increases by V% in next five years.

160. **A number of parallel changes in the budget system are likely to be required.** Quite obviously an examination of the above requirements indicates that this second phase could be a lengthy process, requiring both the MOF and line ministries to build up new management capabilities and introduce new procedures. If fully implemented the repercussions would be much wider. The budget system processes would be considerably changed and this might require legal changes, and certainly changes to the financial regulations (e.g., the budget timetable will most likely have to be lengthened). It might also require changes to the organizational structure within ministries, (and perhaps even between ministries), and inevitably the HR base of budget institutions will have to strengthened either by recruitment or training.

161. **Phase 3. Operating a program-based budget system.** This phase should be viewed as one of consolidation, as all participants in the budget system re-orient themselves away from a centralized budget management model based on detailed controls of line items, to one which is based on policy-relevant programs, managed more directly by the line ministries and with much fewer line item controls. In such a system:

- Budget proposals from ministries would be based on programs, with resource use linked to performance indicators. The latter, with increased sophistication, would ultimately evolve into performance targets for budget managers (see Phase 4 below) to function as a basis for performance management.
- The Cabinet would make resource allocation decisions on the basis of programs, with the priorities based on program contributions to policy outputs and outcomes.[85]
- Appropriations would be approved broadly by function or sector, and if more detail is required, based on the program classification, but no lower than the sub-program level.
- Budget releases would be based on the program classification, and any in-year amendments and virement would be between programs and sub-programs, not line-items as in the past.
- The executive would be given scope for reallocating expenditure within programs and between lower levels of the program classification, with considerable relaxation of line item controls on budget managers, allowing greater flexibility in meeting program objectives.
- Monitoring and reporting for both inputs used and outputs derived would be according to the program structure.
- Accounting and auditing of the financial performance would also follow the program structure, and auditing would be expanded to encompass “value for money” audits to judge a program’s policy effectiveness.
- If the country adopted a medium-term budget framework this would be described in terms of forward estimates of existing programs and the room available for new program spending.[86]
- All the above changes would most likely require changes in budget legislation and well as financial regulations.

162. **Operating such a budget system would yield considerable gains in terms of the efficiency and effectiveness of government operations**. However, to gain the full benefits of program budgeting some countries have attempted to go further in loosening central

[85] It is important that some degree of stability in the program structure is attained to assist in such decisions. In the first years of implementation ministries should be allowed to make necessary adjustments to their program structure as they refine their strategic objectives. However, after this initial period it would be desirable that the program structure be stable and only changed to reflect important changes in strategic priorities. (Robinson and vanEden, 2007, p.73).

[86] In this way future policy objectives, not yet approved by Cabinet, would only be incorporated in the program structure once resources have been allocated to them.

controls and giving budget managers more flexibility. Their aim is to mimic the private sector, giving managers greater freedom to manage their programs while at the same time providing them with incentives to improve their performance. The latter approach necessitates a cultural change within the entire government sector, from legislators to program managers and their staff. A strategy to introduce such changes is summarized in Figure 6.1 and elaborated in the following section.

Final Phase: Moving to a Performance Based Management System

163. **Program budgeting reforms may have started with attempts to change the way budgets are prepared, but in a number of advanced countries they have evolved into a completely different model of PFM, making managers accountable for the outputs they produce**. In this approach, usually referred to as performance or results-based budget management, line ministry managers at the program level should be held accountable for both input use and outputs to be delivered. In return they should be given reasonable freedoms to achieve their objectives. Not surprisingly this approach takes considerable time to be fully realized, as line ministries will have to be strengthened considerably in their financial management capacity. It is important to appreciate that the move to performance budget management must be seen as the most advanced stage of budget reform and for most developing and even middle income countries some way down the line. Making officials accountable for program delivery rather than financial regularity can only be justified if they are allowed certain freedoms in determining their business processes. Although program budgeting has led to a focus on managerial freedom and a more decentralized approach to budget management, countries vary as to the extent of decentralization[87]. As indicated, these further developments call for a change in culture within the MOF and ministries, and raise important implementation issues:

[87] This can be viewed as a continuum (the five Ds): de-concentration, decentralization, delegation, devolution and divestment, as described in Diamond 2006, pp.75ff.

Figure 6.1. A Strategy to Move to Performance Budgeting

Changes required:

Three Elements to Promote a Performance Reform Strategy	Within budget system management	Supporting budget system reforms
Increased flexibility	• reduction in line item specificity • carryover of end-year unused appropriations • Managers given greater authority in resource allocations	Strengthen financial management
Certainty in resourcing	• strategic planning • medium term budget frameworks	Suitable institutional framework
Pressure to perform	• apply pressure on agencies from above • increase capacity from below	Improved accountability framework

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- **The Ministries will have to be sufficiently strengthened in their internal financial management.** The traditional, usually highly centralized, budget system typically involves an excessive number of referrals to the MOF for agreement to relatively minor changes in resource allocation. This removes any real incentive on spending ministries to improve their forecasting ability or management capacity since they can always be second-guessed by the MOF, who in effect takes over their work. In the new decentralized environment it should not be necessary for the MOF to conduct a detailed scrutiny of the spending ministries' inputs. This, of course, requires considerable trust in the ministries' ability to forecast accurately, budget realistically, cost programs comprehensively, and manage those programs efficiently. Such trust will have to be earned through demonstrable expertise. The corollary of such trust, however, should be a greater degree of delegation of authority to the spending ministries for managing the delivery of their programs. This will involve decisions to use different inputs or different mixes of inputs to achieve the required outputs within an agreed budget, without the need for separate approval from the MOF, except where the scale is significant or in contentious cases.
- **The MOF should be prepared to give ministries greater flexibility in budget management.** Once ministries have demonstrated their ability to forecast accurately and manage the delivery of their outputs, it will become possible to allow them to carry-forward any unexpected end-year under-spending. The application of strict annual limits invariably leads to inefficient use of resources, as previously indicated, end-year surges of expenditure are common in countries where there is no flexibility

to carry forward under-spending. It should be noted that several OECD countries allow some carry-forward of under-spent budgets (usually for investment spending[88]). Similarly, if ministries perform more efficiently and experience savings, they should be able to retain at least some of these savings in future budget allocations. Such policies are regarded as beneficial because of the increased incentive they provide to ministries to manage their expenditure efficiently and avoid wasteful end-year spending.

- **Ministries should be pre-qualified for greater flexibility in budget management**. It is important to stress that moving to a more decentralized performance based budget management system should be introduced in a phased way. Since there are obvious capacity differences between ministries, it is suggested that ministries should be pre-qualified for the introduction of these reforms. For example, ministries would only enjoy enhanced flexibility if they meet certain benchmarks of financial and budgeting skills, among which are:
  (i) their accounting is timely and accurate, with full reconciliations;
  (ii) they display prompt payments, with no arrears on any direct payments made;
  (iii) they have good revenue management with minimal arrears in their collections;
  (iv) they have the capacity to project forward their resource needs accurately;
  (v) external and internal audits reveal few problems and those that are revealed are promptly addressed;
  (vi) they have a strategic longer term plan;
  (vii) they have a policy-based program structure aligned to this strategic plan;
  (viii) they have sound indicators of program performance which they can regularly monitor and report on.
- **Decisions will have to be made on the degree of flexibility offered.** Once qualified ministries would progressively be allowed greater flexibility and autonomy from the MOF in their financial operations, for example:
  (i) their budgets would be prepared with a reduced number of line items, which will obviate the need to continuously refer back to the MOF for virements[89]
  (ii) they will be able to retain a significant part, (say, up to 80%), of any savings, to be redeployed within their ministry for purposes that can be proved to contribute to their strategic objectives;
  (iii) they would be allowed more flexibility in carry-overs at the end of the fiscal year, especially for investment spending;
  (iv) any centralized internal audit by the MOF would be decentralized, so that ministries would be given their own internal auditor that acts as a part of the ministry management team;

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[88] Several OECD countries allow end-year carryover of operating costs, although a number of restrictions apply.
[89] However, there are usually some limitations imposed on the ability to substitute between main elements of the economic classification, for example, into personnel expenditure or away from capital.

(v) they would be allowed to make their own payments, and would be expected to prepare and sign off on their own accounts;
(vi) ultimately, they should enjoy greater human resource flexibility, but this will, of course, require much wider public administration reforms that would added great flexibility to presently existing systems of recruitment, promotion, and firing in the public service. These reforms have typically been difficult to implement.

164. **Decisions will be required to provide incentives to change.** Initially the MOF must provide incentives for managers to adopt this new management culture. One strategy is to apply pressure from above to encourage these changes while at the same time increasing capacity from below to allow them to change successfully. Top-down, the MOF could introduce a system of detailed program evaluations to review ministry operations on a regular cycle. It could experiment with market-testing and benchmarking where appropriate, and impose efficiency dividends on future budget allocations to force managers to find savings and increase efficiency. From below, the MOF should be prepared to assist managers to perform better by providing information on best practice, introducing management training schemes, and assisting with personnel recruitment and retraining. Another approach will be to provide incentives to managers such as introducing schemes to publicly recognize achievement and linking pay to performance. Also it is recommended that consumer feedback should be institutionalized. Performance data is traditionally directed to two questions: how well services are delivered (efficiency), and whether planned objectives are being met (effectiveness). Increasingly a third type of question should gain in importance—whether consumers are satisfied with the results (quality). The latter has been found to provide a powerful push to improve service delivery in a number of countries.

165. **These reforms are fundamental and should not be rushed.** The scope of the above implementation issues associated with the move to performance budgeting indicates that this final phase is fraught with difficulties and cannot be rushed. This reform is an archetypical high risk undertaking: de-concentrated, takes time to implement, and requires significant behavioral changes. Due to this, it is critically important not to under-estimate the level of management skills required to adopt a performance budgeting system. Therefore, before advancing on this phase of the reform path it is important to determine who is going to manage the reform process and who is going to manage the new system being introduced. In countries where there is no great depth of managerial expertise in government, perhaps the best policy is to wait until this capacity is developed. Indeed it should be recognized that only a small percentage of countries have progressed to the stage of using performance information in their budget process in the systematic way previously described.[90]

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[90] See T. Curristine, 2007, for a review of OECD experience with performance budgeting. Even within those countries that have, few would argue they have been completely successful, see OECD, 2005.

III. DECIDING THE SEQUENCING OF PFM REFORM ACTIONS

A. Chapter VII: Sequencing as One Component in Reform Design

Summary: *This chapter places sequencing in the wider perspective of the reform decision process to highlight how practical sequencing solutions are shaped by each stage of this process. This review stresses that to be successful sequencing should: not be regarded merely as a technical problem; offer flexibility to reform managers to manage the risks inherent in the reform process; and, be structured to ensure the widest support. The review suggests that no single universal sequencing strategy is likely to fulfill such requirements, but rather individual sequencing solutions must be geared to the country specific environment and be implementable in that environment. Further study is proposed to empirically determine the main factors influencing success in sequencing decisions.*

A Schematic View of the Reform Decision Process

166. **The role of sequencing in PFM reform should be placed in proper perspective as one element in a much wider process.** It needs to be recognized that questions of sequencing cannot be answered by purely PFM technical analysis. While it is desirable that technical PFM considerations should lead the sequencing decision process, the reality is that decisions on sequencing are only one component in the design of PFM reforms, and should not be divorced from other aspects of that wider process. Consequently, even with "technically correct" decisions being made on sequencing reform actions, these actions can still fail due to other problems in the reform design. To identify the many ways how this could arise the reform decision framework is reviewed which, for illustrative purposes, is summarized schematically in Figure 7.1. This highlights seven critical decision points each of which the sequencing literature has recognized as having a potential impact on the success of sequencing.

Figure 7.1 Schematic Decision Framework

Let us take each of the steps in this framework in turn.

Stage One: Analysis and Diagnosis—PFM Technical Factors

167. **In the unlikely event that reform design was to start from a tabula rasa, ideally the first step would be to diagnose a country's PFM problems, through various filters**: PEFA assessments, PERs, PEMFARs, CFAAs, CPARs[91], IMF ROSCs, country surveys by regional IFIs, diagnostic documents by donors in the field, reviews of previous reform initiatives, etc. In this ideal scenario, at this stage other donors, the local authorities, and other interested domestic parties, such as important Civil Society Organizations and NGOs, should all be consulted. The end result of this stage would be to identify all PFM areas requiring reform action. In this way the problems faced by the PFM system would be clearly identified, and by review of what has worked and failed previously, a better understanding would be reached on what types of reform are technically realistic given the country environment. This should involve choosing reform activities that are relevant to the country's overall PFM priorities.

168. **In this Background Paper a two stage process was suggested for sequencing.** Top level priorities, it has been argued, are defined technically by the main deliverables of a PFM system, which, in the order suggested in Chapter II, are: financial compliance; macroeconomic stability/sustainability, and efficiency and effectiveness in service delivery. These three objectives would define the highest level "platforms" of PFM system performance. At this first and highest level of sequence decision-making the following questions should be addressed: Does this country's PFM system need to strengthen its financial compliance? If compliance is judged sufficient, does it need to build macro fiscal capacity? If both the above skills and processes suffice, does it need to develop greater policy effectiveness and efficiency in service delivery? Once the top level reform priority is identified, then sequencing decisions will move to second level: which reform actions are best suited to contribute to the priority chosen, and how are these actions to be ordered and in what time frame?

169. **This paper has proposed the use of the PEFA indicators in deciding lower level sequencing.** There is a strong likelihood that the majority of LICs will find themselves at the first level of reform with an identified need to strengthen some aspect of core financial compliance. The various dimensions of financial compliance are comprehensively covered by PEFA. If, as indicated in Chapter III, there is agreement on what constitute "core" PFM functions, how these core functions would map to the PEFA indicators, and what required PEFA "core" rating should be expected, then it would be possible to use PEFA to identify a menu of possible reform actions. Unfortunately, this overly simplified picture is complicated by a number of factors:

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[91] While these are World Bank documents, they are often co-written and endorsed by other donor agencies as well as government entities such as finance ministries.

- **The problem of generally weak LICs PFM systems**. The above approach may make decisions on sequencing more manageable but it will still not practically solve them. What happens if a country scores poorly in a PEFA across-the-board, and fails to meet "core" target ratings over a wide range of indicators? Indeed, it is likely that many LICs find themselves with a long checklist of possible reform actions in order to reach their target "core" PEFA scores. Resolving this dilemma is the fundamental problem of sequencing. This directly addressed in Chapter X that describes a methodology to address this problem.
- **The problem of on-going PFM Reform Programs.** Another complication arises from the reality that very seldom can the technical determination of PFM needs assume a tabula rasa. It is probable, given the stress donors have placed on developing countries' PFM systems, that there are already on-going PFM reforms that lie outside the agenda identified by the process described previously. Moreover, there may be parallel reforms underway, such as sector reforms, say, in education or health, or general public administration reforms that will impact any PFM reform activity. Such on-going reforms are likely to have important stakeholders both domestically and also within the donor community. It may thus be tempting to ignore them in planning future PFM reforms, or run them on a parallel track. Yet for most LICs, even if fully donor funded, such an option is not without costs in terms of the absorption of scarce change management skills and human resources, not to mention the costs in political capital.

170. **Given these important opportunity costs it is recommended that an explicit strategy be adopted regarding such on-going reforms**. In formulating this strategy it may be important to ask such questions as: Are there any elements in on-going reforms that could be terminated? Are there any elements that can be modified or delayed? Are there any elements that could be incorporated in the proposed reform agenda? What would be the costs and benefits of each, or a combination of, these approaches? If the on-going reforms are to be continued what are the costs and benefits to the proposed reforms? An approach to this problem, consistent with the methodology used to decide sequencing is suggested in Chapter X.

Stage Two: Analysis and Diagnosis—Factors External to PFM

171. **The previous review of the sequencing literature revealed that almost all experts in the field stressed how non-technical factors heavily influenced the design and the success of reform initiatives in the PFM field**. Indeed, it was suggested that in designing reforms it may have to be accepted non-technical factors could override purely PFM technical factors in determining priorities and the sequence *of* reform actions, both the order in which they are undertaken and the timing required for their completion. However, while there was general agreement in the literature on the importance of non-PFM factors—"external factors" — there was no consensus on what they were, although it was agreed that they vary between countries in importance. Unfortunately, the apparent scope of these external factors that have been identified in the sequencing literature, (mostly descriptive in

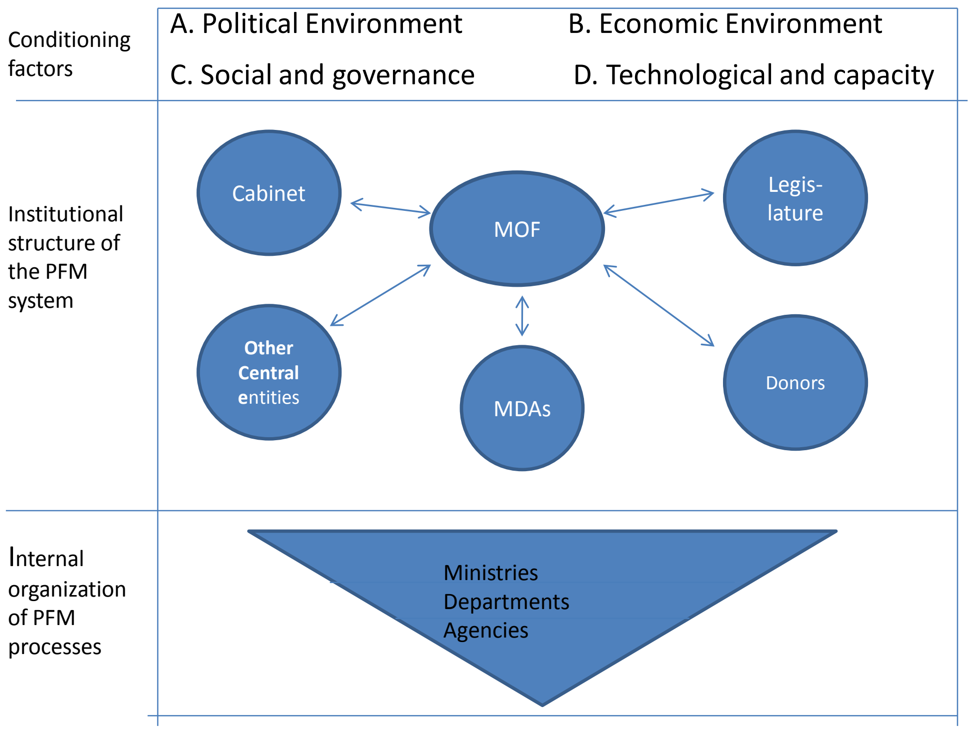
nature) is very wide. There are evident overlaps between contributors, but also some differences in focus and in opinion. Recognizing this as an important area for determining the sequencing of PFM reforms it is suggested that these political economy and organizational factors should be inventoried, a subset of most important factors agreed with some quantifiable indicators derived. For analytical purposes, this paper proposes to divide these external factors into three tiers:

172. **At the highest level, an environmental scanning framework is suggested to identify and order the broad external influences in the PFM system's environment which can affect the success of reform initiatives**. These *conditioning factors* are divided into four broad categories: political environment; economic environment; socio-cultural and general governance environment; technological and capacity environment. The four dimensions are employed to map out the external environment in which the PFM system of a country must function. On each of the dimensions specific factors are identified that are mentioned in the sequencing and general change management literature as important in influencing the success of PFM reforms. To bring these general influences to something more quantifiable and hence useful for empirical verification, possible indicators for these factors are also suggested.

173. **At the middle level are grouped some relevant factors that arise from the institutional design of the PFM system itself.** This covers the PFM system at its broadest definition: including critical relationships as they impact on PFM between the legislative and executive branches of government, the critical relationships with the executive, especially the role of the MOF, and the relationship between the MOF, line ministries and other relevant central government entities. The aim is to identify specific factors in these interactions that could affect the success of any reform initiative. For example, much of the sequencing literature has stressed the importance of a strong finance ministry as the driver of reform. This section identifies some qualifications that result from the type of government system, the limitations placed on the MOF's influence over PFM issues, and its dependence on other institutions to successfully implement reforms.

174. **At the lowest level are grouped some relevant factors that arise from internal organization of PFM processes.** This covers influences on reform success that arise from the structure of organizations, the managerial culture, the limitations of leadership and skills available, and other capacity constraints often found in public institutions especially in the LICs. The aim is to identify critical constraints on successfully implementing PFM reforms in public entities. An outline of this framework is shown in Figure 7.2.

Figure 7.2 Classification of Political Economy Factors in Reform



175. **These external factors are analyzed more fully in Chapters VIII and IX, and a method suggested whereby their impact can be accommodated when making sequencing decisions**. Based on this analysis, it is proposed that a checklist of risks arising from these various sources be formulated to guide reform design in countries trying to improve PFM core functions, and to assist donor delivery of reform support. This is described in Chapter X.

Stage Three: Settle on a sub-set of reform options

176. **Once the first order priority has been decided and the wider context for reform reviewed, the reform actions directed at that priority should be chosen**. This choice, taken at the highest level, will involve at least three important dimensions: *what needs to be done* to reach the top level PFM priority? (largely, a technical PFM question); *what can be done?* (determined by the external factors encountered, and the constraints they impose on reforms); and what the authorities *want to be done* (mainly a political question). Any solution is likely to be a compromise, since it is highly unlikely that all three dimensions will be fully aligned. It is essential that the design and sequencing of reforms operate in a common area, where what is needed, what is possible and what is desired overlap. It would be dangerous to let any one of these dimensions dominate. It is argued in Chapter VIII that the role of change managers is to successfully arrive as such a workable compromise.

Stage Four: In dialogue with interested parties, come to agreement on reform actions

177. **At this stage it will be important to reach a consensus with all stakeholders on the scope of reforms, clearly differentiating those actions needed from those possible and from those desired**. The reform actions satisfying all three requirements should form the core of the reform program (i.e., there is agreement that they are needed, feasible, and supported). At this stage the decision process should focus on reaching 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. Indeed, in the literature, it is possible to detect some dissatisfaction with how this stage of reform design has worked in the past. Some complaints that have been registered are:

- **Reform activities are too broad and overly ambitious in scope.** There seems an in-built bias in the PFM area to be over-optimistic about what can be achieved and to under-estimate the time required. This also seems a common feature of large scale public projects. Given this predilection for optimism it would seem prudent to bias reform in the opposite direction: keep reforms as modest as possible, as narrow as possible and allow maximum time for their completion. Admittedly, this is often a difficult position to sell to stakeholders.
- **Donors push their own standard solutions.** Despite lip service to tailoring 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. As indicated above, 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".[92] How to guard against this is not easy. However, a useful start would be if donors commit to periodic cross-country reviews of their standard "international reform products", for example, like the recent reviews of the experience of FMIS and MTEF projects undertaken by the World Bank. Another such candidate would appear to be the advocacy of program and results based budgeting.[93]
- **Politicians too acquiescent to donor proposals**. Part of the explanation for the previous two concerns arises from the way local authorities enter into dialogue with donors. Donors want reform programs, it justifies their existence. Bigger programs make them more important in countries and at HQ. There are many providers in this field so competition assures an inherent pressure to push reform programs on

[92] "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)

[93] Andrews identified this as one of the standard "reform products" advanced by donors in Africa. From the high level priorities presented in this paper, such reforms would be at the higher level of PFM development, yet Andrews found that 25 out of the 31 countries studied included this element in their reform strategy. (Andrews, 2010, p.43).

countries. Politicians have insufficient technical knowledge, and little incentive to say no to reform proposals, even if not fully committed to them. Given the usual political cycle, the time horizon of the politician’s calculus 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 period. There is a bias to acquiesce to donor proposals in decisions where political benefits (and resources) come up-front and costs (if any) much later. Most donors stress that the local authorities own and lead the reforms; however, how this commitment is evidenced and sustained deserves more consideration in the design of reform programs. Similarly, how a third countervailing power like CSOs and NGOs can be strengthened and enlisted to counter this political bias also may repay further study (see discussion of Stage 6 below).

- **Alternatively, donors concede too much to local politicians.** Choosing reform activities on the basis of local demand also has its downside. Much depends on how credible the authorities’ agreement is, and its previous track record in delivering reform. In many developing countries reforms will be chosen to cause the least discomfort to stakeholders in the system, and often on the basis of maximum rent earning potential. Obviously, getting the authorities to own and lead reforms is essential, but in some contexts if taken too far could prove risky and may involve PFM trade-offs. Given the previous concerns, donors should perhaps more explicitly re-examine how far technical PFM considerations should be compromised to fit a country’s political economy context (discussed further in Chapter VIII).

Stage five: Decide sequencing of reform actions

178. **It has be argued in this paper that successful sequencing decisions are unlikely to be based on purely PFM technical grounds, and will be specific to each country’s circumstances**. Within these limits, ideally these decisions should be based on two considerations: the order of reform actions and their timing. For example, there are likely to be different approaches to choosing intermediate objectives or “platforms” on which to meet the first priority of a PFM system, i.e., to build overall financial compliance in a PFM system. Unfortunately, the more economically rational approach of choosing the areas where the potential benefits are greatest and the potential costs, (including political costs), are least, is not much in evidence. Rather, in practice it is possible to identify the following approaches:

- **Tactical.** Choose the PFM area that will yield easy demonstrable success, i.e., “picking low-lying fruit first”. Once this area is resolved, it is argued success will give momentum to further reform actions, moving to fruit higher up the tree. This takes the view of reform as a learning experience for the reformers that will be reinforced by success rather than failure early on. However, the approach may also result in discouragement if success does not come as easily as expected, or does not yield significant improvements in the ultimate objectives of reform. As previously noted the approach could be counter-productive in that it may bias the selection of reforms in unfortunate ways. The approach, it has been argued, tends to encourage more up-stream PFM activities where gains can be made in changing laws, regulations and organizations and where the main players are concentrated, to the neglect of what may be more important reform activities requiring behavior changes in de-concentrated situations (Andrews, 2010).

- **Weakest link first.** Choose that area that is the weakest, based on the fact that a system is as strong as its weakest link. PEFA indicators can help identify the weakest areas e.g., those with a D rating. However, if there are widespread weaknesses in the PFM system it may not be easy to identify the weakest link, so assigning reform priorities may not be clear cut and become subjective. Conceptually, if PFM is viewed as a system, it is difficult to argue one part of the system is more important than another. However, it should be conceded that there are likely to be some evident cases where it is possible to technically identify bottlenecks that require to be removed first before further reforms are possible.
- **Local demand.** Choose the area where the authorities have most interest. This, it is argued, will ensure maximum political commitment to the reform. If political support is lukewarm, it may only be necessary to have a technocratic champion in the bureaucracy of sufficient status to push reforms. Ownership of the reform effort is something that should be strived for, but the danger may well be that certain reforms become associated with a particular political figure or an administration, and may be abandoned if the political figurehead loses power or the administration changes. It must also be remembered that when governments change most often the top bureaucrats are changed as well.
- **The platform or staged approach.** As discussed above, this approach focuses on supportive reform activities packaged together, that would then form a logical sequence for reform. In this way once one package of activities is completed it will form the supportive basis, or "platform", to move on to a further package of complementary reforms.

179. **Each of these approaches will be reviewed further in Chapter X, using a risk based approach to sequencing.** In that chapter it will be stressed that the sequencing strategy adopted should ultimately depend on the type of reform actions that are sequenced. Specifically, five important dimensions of any reform action are highlighted: the scope of the reform, and its degree of complexity; the time required to complete the reform action; the degree of behavior change that is involved in the reform; the number of agencies that are involved; and its degree of "visibility". All dimensions tend to be highly correlated, in the sense that more complex reforms generally take more time, involve more behavior change, are spread over a number of different institutions and, because of all this, tend to have pay-offs that become visible only with time. Each dimension adds to the risk of any reform action, so that each reform action will have a particular risk profile. It will be argued in Chapter X that in reform design it is necessary to match the risk profile of the reform program to the risk profile of the country.

Stage Six: Put in place an adequate delivery mechanism

180. **From these design questions it will then be necessary to turn to implementation issues**, (and it should not be forgotten that ultimately the purpose of any guidelines in this area is geared to improve the future delivery of PFM reforms). Three requirements for successful reform delivery have been stressed in the literature:

- **Ensuring constraints are removed and resources are in place.** The first priority will be to address any external elements that are felt to impose too much risk to the reform actions. This approach that does not seem much emphasized in the literature, should pose questions such as: What actions would counter the risk? How long would this take and at what cost? If the cost is too high should the reforms wait, or be modified or other reforms selected? Often constraints are defined narrowly, focusing on financial constraints, perhaps the easiest to tackle. Human resource constraints are often highlighted and sometimes explicitly addressed within reform actions including training, re-training, exchange programs etc. However, often resource constraints are not viewed on a long-term basis. The focus tends to be on what is required to implement the reform, rather than on the recurrent resource needs afterwards. The latter requires a plan for institutionalizing reform: that is, how the selected reforms will evolve from “reform efforts” to standard operating practice before donor assistance ends. It is not always clear whether this longer-term view of resource needs actually is addressed, or if it is, whether on a consistent basis.
- **Ensuring local participation, ownership, and pressure for reform.** Donors have recognized that maintaining the momentum of reform is challenging given the typical long-term nature of PFM reforms. To maintain reform momentum local ownership and participation are recognized as essential. Two strategies have been advocated in the literature: improving incentives for, and widening the ownership of, reform. Regarding the first strategy, three categories of incentive have been identified as important: increased accountability derived from central controls; personal reward; professional pride and community pressure. Meeting the need for increased transparency and improved internal controls have been a feature of PFM reforms themselves. The need to reform public service in terms of reducing numbers and increasing pay has also been adopted as a common parallel reform. [94] However, the third set of incentives probably still needs more emphasis. Peer pressure or competition between managers has been advanced in some reforms, such as the “hurdle approach”, qualifying managers for greater responsibility. Typically, donors have turned to indirect incentives, such as providing training opportunities and exchange assignments. Recently, more emphasis has been placed on the second strategy: widening ownership of reform by strengthening institutions pushing for domestic accountability, such as Civil Society Organizations. How to empower and engage such institutions, and the increasingly important NGOs, remains an on-going

[94] Indeed, some such as Allen, 2009, would see PFM reforms predicated on parallel public administration reforms.

challenge worth exploring further. It is suggested that it would be extremely useful if any future strategic review of reform design and sequencing should document what has and what has not worked in this area.

- **Adopting an adequate change management strategy.** The importance of change management to PFM reform delivery, especially in addressing the above two issues, has been increasingly recognized. The role of change management has focused on two dimensions: change champions or political sponsors who demand and support change and help build constituencies for change; and, change managers, i.e., senior civil servants to lead the management of the reform program. Reform programs attempt to identify both these elements, but often this is difficult. It has been argued that often the best that can be expected is that the political support will be lukewarm or at least non-obstructive, and this may suffice as long as there are technocratic champions of change.[95] An important aspect, which is perhaps not fully addressed in the literature, is the degree of stability in change management that is often assumed in implementing reform programs. Reform programs often cover a number of years, and within the reform period politicians may change and with them champions will disappear. It is perhaps no coincidence that reform programs in developing countries often quoted as successful, (such as Cambodia, Uganda), also have involved political regimes that have not changed in a considerable period of time. But what of other, less politically stable regimes? Is there a continuity plan in place to take reforms forward should there be a regime change? This is likely to require widening the usual change management strategy in order to widen the domestic pressure in support of the reform. While recognizing the importance of change management in the delivery of PFM reforms, it is also important to appreciate it also has a role in the overall design of the reforms, including the important dimension of sequencing. Indeed it is possible to argue, as in the following chapter, that change management can be viewed as risk management of the entire reform process.

Stage Seven: Formal monitoring and review of reform efforts

181. **At present there appears to be too little stress placed on ex post evaluation of reform programs**. Formal monitoring of reform projects usually is bureaucratically standardized, aimed at keeping the project on track, not reviewing more fundamentally if the track is still the correct one. The review function is typically country specific, and not undertaken across a range of like countries or like reform programs, where the learning process would be deeper and provide greater guidance to corrective action. As argued throughout this section, this gap should be filled by a strategic review of the sequencing of PFM reforms. For example, why is it that almost universally the time required for reforms is under-estimated? All donors warn of the problem, and have done so consistently, and just as consistently have failed to avoid it. The literature contains many suggestions for avoiding the problem: by slowing the roll-out period to allow learning on the job and ensuring changes are internalized; by allowing for "pauses" or periodic digestion and consolidation periods in

[95] See Hedger and Agha, 2007.

reform design; by not neglecting a handover period, etc. Almost all donors highlight the importance of getting the pace of reforms and the timing right in the phased implementation as critical in ensuring that reforms remain on track. Despite this emphasis the problem remains, and would seem to indicate this is a prime area for a systematic review across donors and across countries to derive some guidelines on average time requirements for different types of PFM reforms using a common analytical framework.

Some Messages Derived from the Literature

182. **A number of points have emerged from this review that are relevant when discussing sequencing in PFM reforms, and that will guide the discussion in subsequent chapters:**

- **Sequencing is only one component of reform design**. Due to this, sequencing is unlikely to be successful if other aspects of the reform's design are not viable.
- **Sequencing should never be regarded as just a PFM technical issue.** The sequencing literature indicates that it is not so difficult to technically analyze and diagnose technical PFM requirements. However, to reach practical sequencing solutions involves taking into account non-technical external factors which could prove decisive.
- **Sequencing should offer flexibility in reform design.** When designing reform there is room for being proactive to make efforts to expand the areas of what can be done, or what is demanded. This implies that change managers can and should influence the sequence of reforms to ensure this.
- **Sequencing decisions should be made with a view of ensuring enduring support.** To accomplish this, it is essential before moving to any discussion on sequencing to first secure wide support for the reform actions being contemplated.
- **An optimal universal sequencing strategy is unlikely to exist.** No one sequencing strategy is likely to work in all environments; indeed this paper argues a mixed strategy is probably required for most environments.
- **Sequencing must be implementable in any specific reform environment.** No matter how much effort is made to determine the "best" sequencing of reforms, the practical value of such effort rests on the willingness and ability of reform managers to implement them.
- **Sequencing decisions need to be grounded empirically in past experience of what does and what does not work.** As yet there has been no review of the overall sequencing strategy of PFM reforms. Clearly the discussion in this Background Paper is only a starting point and would benefit considerably from being anchored in such an empirical study.

B. Chapter VIII: Assessing Reform Risks at the Top Political Economy Level

Summary: *This chapter addresses the problem of top level external factors, or conditioning factors, that often limit reform choices and determine sequencing decisions. It is argued that in accommodating these factors change management is essential to find a viable reform solution, and an agreed sequence for reform actions. This should minimize risks to reform success while ensuring reforms have the desired impact. The chapter offers an inventory of such top level external factors, and describes how their risk impact on PFM reforms could be analyzed. In doing so it stresses the importance of accommodating informal PFM systems and parallel reforms, as well as indicating limits to how far technical requirements should be compromised to meet political economy demands. It warns that donors should be selective in their approach to countries, and be prepared for extreme cases where risk is so intolerably high that meaningful reform is not possible (although, of course, emergency assistance may be justified).*

Change Management is Essential to Address the External Factors

183. **PFM reforms essentially involve introducing changes in an open system that is highly influenced by many outside factors that impact the system at all levels, as well as its structural architecture, that determines how these factors interact with PFM functions**. These factors are characterized as "external", signifying they lie outside purely technical PFM considerations, but should be recognized important because they pose risks to successful PFM reform. Reform initiatives must be able to successfully navigate and overcome these risks. To achieve this, as suggested in the previous chapter, required the intervention and mediation of active change management both in the design and implementation of reform actions.

184. **Change management theory offers some insight into how this intervention may be accomplished successfully.** In their extensive review of the literature on implementing planned changes in the public sector, Fernandez and Rainey (2006) stress that the first and perhaps most important step in change management is to create demand for change.[96] From this viewpoint the scope for introducing change is determined by the degree to which it is possible to demonstrate the need for change, create an alternative vision of the benefits derived from the change, and so increase the degree of dissatisfaction with the status quo. In this way the initial aim for change management is to create demand for reform in the system. However, demonstrating the benefits of reform and creating dissatisfaction with the status quo is a necessary but not sufficient foundation for change. To turn this "potential" demand for change to "effective" demand requires enlisting a powerful enough coalition around the need for change to drive the reform, with an empowered leader to steer the reform, and the existence of credible strategies to achieve the new "vision". Only by generating a strong

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[96] This they place as the first factor in managing change, as evidenced from a number of examples they quote from the private and public sectors (see pp.9ff).

enough demand for reform in this way will it be possible to overcome the resistance in the system to any change in the status quo.[97]

185. **When enlisting local demand to support reform it is evident that different reform actions have different degrees of "visibility" or political attractiveness**. Some reforms require demonstrable actions that bring them to the attention of the politicians and the public, while others are covert and hardly appear on politicians' "radar screens". The former may not necessarily prove fundamental to PFM reform, but their visibility allows politicians to demonstrate action, and is good for public relations. The resulting support that these reform actions are able to generate enhances their chances of success. On the other hand, low visibility reform actions may be important in PFM, as say when improving accounting and reporting, but are not likely to be politically attractive. Their implementation lacks visibility as does their impact, and due to this reforms will likely find it difficult to recruit a reform champion or enlist public support. The resulting lack of support adds to the risk of failure.

186. **The way that reforms are promoted is important.** It has been pointed out that the failure to sell a "basics first" approach to PFM reform to politicians arises from the very term "basics" itself as offering little attraction to politicians who want to demonstrate something more to their electorate. Unfortunately, this need to "sell" reform actions to politicians and the public may lead to certain biases. Given the short time spans in which most politicians operate, this could lead to choosing reform actions that can be completed in a short time period regardless of their overall reform impact. If reforms fail to meet the politicians' short-run needs to demonstrate reform impact they will likely withdraw support. This aspect cannot be ignored by change managers: high visibility reforms may have a possible positive impact on other reforms, a "demonstration effect", that low visibility reform actions lack. The argument implies that risk of failure will increase as the lack of "visibility" of reform actions increase.

187. **This critical first step, creating the demand for change, is not easy in the hostile environments that often exist in LICs.** Indeed it is likely to be the most problematic task for change managers. This first step in reform planning—that of analysis and diagnosis of problems, the identification of those reform areas that have local support, and the organization of this support against the status quo—has been previously described. It was stressed that even if reforms could enlist sufficient local demand, this would have to be balanced by what was technically required and what was practically possible. For example, reform cannot succeed if the reform actions demanded are judged not to be feasible due to the constraints faced by the country. Similarly, the reform actions that are demanded may be feasible, but they might not meet the PFM priorities judged essential to that specific country.

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[97] This is in line with Gliecher's view that meaningful change is derived from generating dissatisfaction with how things are now. This he expresses in his formula for change D x V x F > R **;** D = Dissatisfaction with how things are now; V = Vision of what is possible; F = First, concrete steps that can be taken towards the vision; R = Resistance

As an extreme case, reforms demanded for their "visibility" or attractiveness to politicians could conceivably be irrelevant to the country's real PFM needs or what is feasible.

188. **Demand for change must be tempered by what is possible and what is required.** This confronts the change managers with their second critical step: that of seeking a viable reform solution that offers a workable compromise between what is technically required, with what is feasible given the constraints imposed on the formal PFM system, and with what can be "sold" to policy makers as requiring to be changed. The resulting solution, both the reform actions chosen and the order in which they are to be executed, consequently can never be considered purely a technical matter, but are determined by this trade-off. Schematically the situation can be represented in Figure 8.1 below:

Figure 8.1. Deciding on Available Reform Options

What needs
to be done?

What can
be done?

What is
wanted?

189. **For success in reform the change mangers must find the common ground between these three dimensions of the reform problem, and operate within these bounds**. However, the solution should never be considered predetermined, rather change management should be proactive. It should be directed to moving the three dimensions closer together and enlarging the degree of overlap; and/or enlarging one of the dimensions—for example, increasing the scope of what is demanded and removing constraints so as to enlarge the scope of what is possible. In some country environments reaching a feasible compromise may be very difficult, and perhaps it should also be recognized as not possible in some extreme situations (e.g., in post-conflict states).

Deciding on What is Possible in PFM Reform

190. **While determining what is required to reach different levels of PFM deliverables is largely a technical exercise, deciding on what is possible requires assessing the external political economy environment of PFM reforms**. Indeed, there has been increasing realization of the importance of analyzing the political economy setting for any substantial reform initiative, including those in the PFM area. Accordingly, many donors have acknowledged the value of such analysis for any proposed reform intervention to avoid wasting scarce development resources.[98] Notwithstanding the political sensibilities that are often raised in opening a dialogue with recipient countries on such issues, there seems little

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[98] See OECD, draft PPCM Guidance, Chapter 4, Assessing the Country Context, draft 3/8/2011; see Fritz et al, World Bank (2009), p.vii.

doubt that such dialogue is a crucial precondition for judging the feasibility and ensuring the viability of many developmental reforms, including those in the PFM area. There is a consensus that this dialogue should utilize a broad-based approach, that not only focuses on the constraints likely to be encountered by any reform, but also the opportunities that exist which, if exploited, can further the reform effort.

191. **Unfortunately, despite a number of valuable contributions and continuing work in the area, there is as yet no agreed operable approach to this risk and opportunities analysis with such broad scope**.[99] Notwithstanding the present state of knowledge, this paper encourages this gap be filled, and hopes that it could be used to provide a productive foundation for the dialogue with the authorities. The aim of such an exercise should be to initially identify the need for PFM reform and to agree common desired areas of intervention. In terms of the reform decision framework (outlined in Chapter IV), this should form an important input at the first step of analysis and diagnosis. It would inform the initial agreement on PFM priorities, with the aim to come to some understanding on the bounds of what is possible in any PFM reform program.

192. **In the absence of an agreed methodology for a comprehensive political economy analysis, as a prototype it is proposed to use an inventory of "conditioning factors"**. These are identified by PFM experts from their discussion of reform design experiences. It must be admitted that by representing only a sub-set of political economy considerations such an inventory is inevitably incomplete. However, it should also be understood the analysis is designed to perform a different function than a full-scale political economy analysis. Unlike the political economy "scoping" analysis that should occur at the initial engagement with the country authorities, it is envisaged that this first tier analysis would be employed as a "filtering device" at a later stage in developing a detailed PFM reform strategy. As a means of assessing reform risk in a particular country context it would act as a "reality check" on the viability of any PFM reform program. In this way its emphasis is different from that of the full scale political economy analysis. For example, the identified factors focus on more immediate political economy considerations rather than the longer-term fundamentals (e.g., accepting present demographics rather than examining future demographic trends). Its aim is to examine the viability of specific reform actions rather than broad reform areas, (i.e., PFM reforms rather than examining the priority between this reform area and other areas in say the health, education, transport etc). It focuses mostly on the risks rather than the opportunities and, because of this, it emphasizes the supply constraints rather than the enabling demand factors.

193. **An environmental scanning framework (ESF) is employed to impose some order on possible influences identified in the sequencing literature that could impact PFM reform initiatives**. The wide scope of the resulting factors is shown in Tables 8.1 A-D

[99] Perhaps the slow progress is not surprising since this is an area requiring multi disciplined teams, and where political economy considerations will differ radically between countries.

(annexed to this chapter), which divide these conditioning factors into the four main groupings associated with the ESF approach. These tables not only identify key factors, but indicate how each factor is expected to influence PFM reform, and suggest how indicators could be constructed to measure the likely importance of each factor (columns 1-3). Using these indicators it is proposed that an assessment be made of the magnitude of impact on sequencing from each conditioning factor that could be expected in a *particular country* context (column 5). This assessment could be no more than a simple ranking consisting of minor, significant, and major. Another column (4) would contain an assessment of the likelihood of this factor coming into play for the *particular reform* contemplated (under the assumption that some reforms will be more vulnerable than others). Again no more is suggested than a simple assessment by a ranking of low, medium, and high. Between them, these assessments of the size of impact and its likelihood allow an assessment of the risk to reform sequencing posed by each conditioning factor for a particular country for the particular reform activity being contemplated. A brief examination of Tables 5A-D reveals a number of issues that invite further investigation:

- **First, it is evident that some factors are more widely regarded as being important than others.** This is highlighted in column (6) that shows the source reference for selecting a particular factor, and indicates the number of authors that have highlighted this influence on PFM reform. This suggests that not all factors are viewed as having equal weight or that some factors have not been explicitly perceived as significant in analyzing reform efforts.
- **Second, there are some obvious correlations likely between the conditioning factor groupings, for example, economic instability indicators are likely to be correlated with political and social instability indicators.** This inter-correlation suggests that it may be possible to either reduce the number of indicators to a few key representative indicators or to suggest important contextual linkages as a basis for identifying different types of reform environment.
- **Third, there are also some conflicting interpretations of a conditioning factor's influence.** For example, does more support from donors exert a positive impact on reform (through greater resource availability, sharing of knowledge, technology and experience) or a negative one (does it encourage dependence, undermine local reform initiative and ownership and weaken sustainability)?
- **Fourth, it is as well to recognize that some conditioning factors could exert an influence at different levels.** That is, assigning a conditioning factor to the top level of environmental influence for any particular country, or with regard to a specific reform initiative, will depend on the contextual analysis. It is possible a factor may exert more influence at the internal operational level rather than as an external environmental driver. For example, the technological capacity of a country, and in particular the extent of IT expertise, is typically assigned to the environment level in an ESF analysis. However, this influence on reform success may be more pronounced at the lowest operational level in PFM organizations (see Chapter IX).

- **Finally, there is often an important analytical difference in the way these factors have been identified.** It is as well to note that many of the factors included from the review of the literature were derived from studies, such as by Andrews, which analyzed differences in the level of PFM systems between countries. Empirically it is important to distinguish results from comparative statics, or differences in levels, from the more dynamic concept implied by reform, of changes over time.

194. **Given these issues, it can only be concluded that the conditioning factors and their indicators included in Tables 5**.1A-D would benefit from further refinement, and, in particular, further empirical investigation as to how closely they are associated with reform success.

Change Management as Risk Management

195. **While technical analysis can assist, deciding the content of a reform program is a policy decision.** Following the logic of our schematic view of the reform decision process (Chapter VII), we should initially be able to determine technically what is required in terms of a reform agenda from various PFM diagnostics. If the above environmental scanning framework is empirically carried out for a country, it should be possible to gain an indication of the level of risk faced by any PFM program. This would be an important input in deciding what reform actions are likely to be the most feasibly implementable within that reform agenda. Of course, this sub-set would then also have to pass the test that it matched the political agenda of the government: i.e., these reforms are wanted. The challenge of finding a working compromise in which reform can take place raises some critical questions for the strategy of change management in the LIC environment:

How to accommodate informal PFM systems?

196. **Concentrating on formal systems and ignoring informal ones can be dangerous.** Previously it has been argued that designing and sequencing PFM reforms involves more than technical PFM considerations. However, this problem may be more complicated in some LIC countries. If the technical analysis focuses only on the *formal* PFM system this could be quite misleading as a basis for reform. In many countries even where formal systems exist, and are defined by law and financial regulations, they are often flouted by those in power. Often they have been replaced by informal systems that allow for the extraction of rents, the widespread use of patronage, and the consolidation of political power. Perhaps more fundamentally, the existing "rules" of political engagement and mechanisms of power brokering in many LICs are such as to offer few incentives for those in power to adopt meaningful reform (in the sense of improving PFM deliverables). In this environment any decision framework defining what is needed by following a purely technical approach to PFM reform, determined solely by PFM outcomes, faces two criticisms. First, that it seeks to reform formal systems, ignoring the reality that informal systems prevail. Second, it is doomed to failure because it offers no incentive for those in power to take up the reforms in earnest, since this simply runs counter to the fundamental political "rules of the game".

197. **The existence of informal systems is not a trivial issue and needs to be addressed.** Generally reform is usually framed in terms of moving to some more ideal way of doing things. In PFM this "ideal", (as in this paper), is usually framed in terms of better meeting the outcomes desired from the system, its "deliverables": stronger financial compliance, greater macroeconomic stability, more efficient and effective service delivery. These objectives can only be obtained if all participants in the system are following rules and regulations that are designed to deliver these outcomes, i.e., operating a formal system. Accordingly, PFM reforms can be expected to face a fundamental contradiction since by their nature they aim at improving the formal system at the expense of the informal one. But, runs the counter argument, if rents, confirmation of power bases, patronage etc., are supported by the informal system what incentive will there be for successful implementation of reforms that are aimed at improving financial compliance and hence reducing rents and the scope for patronage? A methodology to make explicit and address such issues in reform design is suggested in the following chapter.

198. **But the existence of informal systems should not be considered a given.** The importance of informal systems cannot be doubted, nor can the distortions that they give rise to. However, from a change management perspective these should not be regarded as a given. These distortions involve costs to someone and hence are likely to be a source of dissatisfaction with the status quo that can be exploited by the change manager. For example, a government officer with powers over cash releases can gain considerable rents or political leverage in the way he exercises these powers. However, the exercise of these powers is likely to disadvantage those who are not favored by the cash releases, or who are unable to participate in an exchange of political favors. This creates a group that will perceive there are gains from reform, and that could be organized to support change. Moreover, a well functioning PFM system, enforcing the rules, procedures and principles governing how decisions over public resources are made and implemented—if well designed and transparently operated—can help alleviate many of problems that give rise to the existence of informal systems in the first place. For example, introducing more realistic budget preparation procedures or a system of financial planning is likely to undermine the power of those who extracted rents from a cash rationing system. PFM reform by strengthening the formal system should weaken the informal. This should be seen as an incentive to support reform by those most disadvantaged by the informal system. It is up to the change manager to understand the nature of the gap between formal and informal systems, why informal systems persist, how this impacts different players in the system, and to help nurture a coalition around those dissatisfied with the present distortions they create in order to drive reform.

How far to compromise with "political economy realities"?

199. **In terms of reform objectives the perfect could be the enemy of the good.** The standards to which most PFM reforms aspire to are those of good practice, as defined internationally (e.g., the PEFA assessment) at an "adequate" level to meet "core" PFM functionality. In this way PFM reform actions are derived from a diagnosis of weaknesses

defined by comparison to some international standards. It should be admitted this "technical" position may be at odds with other approaches to reform. These approaches see a much greater role for local preferences or environmental viability in determining the content of reform actions. Many advocate what they call "best fit", "good enough governance", and "second best solutions" as providing a better approach to reform. For example, DFID endorses an approach it calls "opportunistic": choose activities sought by the authorities to get them involved and then once they are engaged work to turn reform to higher priority actions. The World Bank has recently raised the possibility of "incentive compatible reforms" (Hasnain, 2011), that allow for a parallel track approach: technically determined reforms alongside other arrangements to accommodate requirements for patronage and other political economy considerations.

200. **Choosing reform activities only on the basis of what can be "sold" locally has its dangers when underlying incentives are distorting the PFM system**. In many developing countries there will be a tendency for reforms to be chosen that result in the least discomfort to stakeholders in the existing (informal) system, and often priorities will be set to maximize rent earning potential. While not doubting that flexibility is required to engage the authorities, there should be no doubt that previously mentioned approaches are compromises to accommodate the current political economy situation in order to allow change to be introduced. However, if they are made acceptable enough, these reform solutions run the danger of being internalized by the ruling power brokers and employed for their own purposes with minimal impact on PFM outcomes. That is, "the reform" will be implemented without anything actually being reformed.

201. **Letting the authorities lead reforms is not always desirable.** Obviously, getting the authorities to own and lead reforms is essential, but in some contexts making this the prime driver of reform could prove risky and may involve unacceptable PFM trade-offs. Given the previous concerns, donors should perhaps more explicitly re-examine how far technical PFM considerations should be compromised to fit a country's political economy context.

How to accommodate the influence of parallel reforms?

202. **Reform does not begin from a tabula rasa.** The decision on a PFM reform agenda cannot be made in a vacuum. It is well recognized that the success of PFM reforms cannot be divorced from, and may even be dependent on other parallel reforms. Some of these will have major positive consequences for PFM: for example, many sector reforms, say in health or education, involve not only policy changes but also improvements to the way sector budgets are planned and administered; public administration reforms have the potential for dramatically affecting the efficiency of PFM and undermining informal systems that often constrain formal PFM systems; decentralization reforms have generally been advanced to improve the responsiveness and effectiveness of government agencies. At the same time, such reforms may have negative short-run impacts. Sector reforms may pose problems for the MOF to maintain short-run deficit objectives dictated by macroeconomic conditions; administrative reforms may cause some short-run dislocation in HR recruitment and

incentives; decentralization may at the same time reduce the power of the MOF to implement or influence PFM reforms generally. In addition, all such large scale parallel reforms, perhaps more “visible” in their impact, will inevitably divert politicians' attention from PFM reform (diluting what is demanded) while tying up the scarce management skills available that potentially could slow down the PFM reform process (i.e., reducing what is feasible).

203. **It is important at the initial stage of balancing what is wanted with what is needed, that change managers fully take into account both the positive and negative implications of any parallel reform initiatives**. This implies ensuring that the proposed reforms in aggregate remain within the feasible range, involve no conflicts, and are fully coordinated in their implementation. From the perspective of analyzing the risks to reform, this suggests that apart from examining the risks associated with individual reform actions care should also be taken to examine the risks from a macro perspective that arise from the portfolio of reforms to be undertaken, both those inside and outside the PFM area. Adopting this wider perspective demands a great deal of coordination among the donors and the national authorities, but would seem essential to avoid overloading the authorities and overstraining their administrative capacity to implement reform. In cases of “reform overload” it could be found that although any individual reform when examined individually could display a tolerable risk level by itself, but when all reform actions are aggregated into a portfolio of reforms the resulting risk could be intolerable. The special case of parallel PFM reforms is explicitly addressed in Chapter X.

Reform Implications in Deciding the Feasibility of Reforms

204. **The guiding principle in advancing reform is that there is a good chance of success.** Raising the above issues is not to question the argument that to ensure success reform solutions often require political trade-offs as well as sound technical design. Rather the decision for change managers is one of degree: how much to trade-off? The position taken in this paper is that *reform actions should be advanced to attain certain PFM outcomes, if the risk of not attaining a significant part of these outcomes is too great, (or “intolerable”), the reform should not proceed*. When applying this guideline it should be recognized that the risk appetite of donors will vary, both with respect to the specific country and the specific reforms contemplated. There are some general implications of this guideline:

- **Donors' response to countries should be selective**. The above argument implies change managers would be guided by the objective that any PFM reform action should primarily address identified technical weaknesses. They should accept this as a desirable objective in its own right, rather than the means to other ends that powerful actors might want to pursue. Accordingly, the case for each PFM reform action should rest primarily on the attainment of some PFM objective that represents an improvement over the present PFM outcome. If achieving this outcome is completely misaligned with the interests of the power brokers, then the likelihood is very high that the reform will not succeed. In this case it should be recognized we are still at the first stage of engagement with the authorities, i.e., discovering: who might be interested in PFM reform, in what area, what support there is to build on, and how to nurture common interests between power brokers, and generate dissatisfaction with the present system to drive reform. It is only when this level of engagement has already been reached, does it makes sense to move on to decide between different reform actions. Only then can it be recognized that we have reached the subsequent stage of short-term design and implementation strategy where change management principles can be productively applied. It is this stage of reform planning that is primarily addressed in this paper.

- **A viable reform may not be possible in all cases.** Another implication of the above guideline is that if no significant common ground can be found between what is needed, what is feasible and what is desired, then the proposed reform should be postponed. Donor engagement should then be directed to working towards this common ground: persuading the local authorities that what is needed is also something they should support and demand; and removing the constraints, to enlarge the scope of reform that is feasible, so that it is compatible with what is technically required. This can be viewed as making efforts to lower the risks to reform success—the role of change managers. However, an important part of sequencing is the choice of timing, on when to act and when to wait.

205. **It should be recognized that there may be extreme cases where, in the conceivable future, the risks to reform cannot be reduced to some tolerable level**. In some environments, as encountered in post conflict countries or "fragile states", the political and PFM systems are so dislocated that there is a complete misalignment of what is needed, with what can feasibly be attained and what the authorities want. Nor is it possible to wait to respond in a more enabling environment. In such extreme cases donors should recognize their actions assume a different purpose: rather than PFM reform (i.e., improving existing functions), actions are dictated by the need put in place essential PFM functions where none exist or have completely broken down. In practice this may need to take place outside the regular government apparatus, utilizing other civil society organizations and NGOs. Alternatively, or in parallel, it may also be necessary to restore functions that have broken down, and in some cases completely reconstruct them from what existed before the crisis. Much depends on the state of the PFM system before the crisis, the severity and type of crisis that has occurred, and the resulting PFM weaknesses after the crisis. A recent World Bank study has stressed the very large range of problems encountered in such situations and the impossibility of generalizing a common approach.[100] *In the language of the risk-based analysis presented here, these are extreme cases where risk is so intolerably high that reform is not possible although, of course, emergency assistance may be required.* The nature of such actions, summarized as the "three Rs" in Box 8.1 should not be considered reform actions as interpreted here.

[100] Schiavo-Campo, IBRD, 2012

Box 8.1. PFM Strategies in Post-Crisis and Fragile States

The Three Rs Approach to PFM emergency action in post-crisis and fragile states:

■ **REPLACE**

The government apparatus is so damaged it must be replaced on an emergency basis

Examples: Essential services to population provided through alternative channels such as NGOs; security and judicial services provided by international community; expatriate staff appointed in key administrative line positions; special programs for demobilization, integration, and compensation introduced as a priority.

■ **REPAIR**

The government apparatus that can be salvaged needs to be repaired

Examples: Personnel " lost" in the crisis rehired or recruited; ITC infrastructure damaged in crisis restored; emergency cash payment arrangements due to banking system disruption replaced by Treasury bank accounts; regular budgeting procedures restored to ensure resource allocations favor no ethnic groups or regions; and generally strengthen MOF centralized decision-making on usually fragmented public entities.

■ **RECONSTRUCT**

The government apparatus that cannot be salvaged needs to be rebuilt

Examples: The move from a planned to a market economy requires MOF functions to be reconstructed, planning functions reassigned; moving from severe ethnic tensions or dictatorial/military regimes often requires ministries be restructured, functions such as audit reinstituted, parliamentary institutions restored; budgetary legislation and regulatory framework reintroduced, fundamentally modified, or rewritten.

Sequence needs to be country-specific depending on degree of fragility:

In extreme cases: first REPLACE, by introducing emergency arrangements in the immediate term as required, while taking actions to REPAIR PFM systems in the short-run, and RECONSTRUCT in the medium-term. Note all three strategies can work in tandem.

The aim should be to restore the government apparatus to a level where it is possible to develop a core PFM system, but this action is not **REFORM** as defined in this Background Paper.

Table 8.1 Inventory of Political Economy Influences on PFM Reforms:

A. Conditioning Factors: political context

Describe factor	Describe how the factor impacts PFM reform (positive or negative)	Indicator/indicators to assess impact	How important is the factor for reform: (High/med/low)	How relevant for this country? (High/med/low)	Relevant Sources:
Level of political support for PFM reform.	Impacts legitimacy, leadership, empowerment, engagement and ownership of reform.	Level of shared cross political party support of the reform. Reform part of dominant political agenda. (Plan/Budget Speech) Political engagement in reform: -Top political support (Speeches/Participation) -Determination of strategic vision (Executive Decision) -Support in public dialogue. -Political appointee in charge -Representation on reform steering committee.			DIFD, 2001. Pp.50ff; Bergmann, p.13
Stability in government	Impacts continuity of strategic vision, leadership and ownership arrangements of reform.	No. of years continuously in power; Frequency of party and cabinet changes (in particular Minister of Finance). Closeness to general elections; Prominence of the military			Allen,2010,p.5; Andrews 2010, Dressel and Brumby, 2009 Allen,2009
Status of the political system: a) autocratic or democratic; b) majority party or coalition; c) federal or unitary	Impacts extent to which political leadership can exert power to support/enforce reform; (also impacts power of MOF to lead reform) Impacts on effectiveness of accountability arrangements	Effectiveness of legislative and civil society oversight; Levels of accountability; Distribution of power between coalition members; Clear constitutional mandates for federal and state authorities. Clear rules for intergovernmental transfers. Degree to which these rules are followed.			Dressel and Brumby,2009

Describe factor	Describe how the factor impacts PFM reform (positive or negative)	Indicator/indicators to assess impact	How important is the factor for reform: (High/med/low)	How relevant for this country? (High/med/low)	Relevant Sources:
B. Conditioning Factors: economic context					
Growth rate	Availability of resources for PFM Reform; Level of political demand and confidence in reform as well as focus of PFM reform efforts. - Basics - More Advanced	Average 5 year g/r of GDP; Average g/r over world average			Andrews, 2010
Level of Economic stability (1) Level of Economic stability (2)	Stability positively Influences the pace of, and nature of, efforts to strengthen various components of PFM : - Revenue Mobilization - Resource Allocation - Expenditure and arrears control - Treasury ops. OR Severe instability or disruption is a shock to induce reform	Av. GDP growth in recent 2 years compared to past 10 years. Av. Inflation rate in recent 2 years compared to av. in past 10 years Difference in growth rate of credit compared with nominal GDP in 2 recent years compared to av. over last 10 years Real rate of interest in recent 2 years compared to its average over last 10 years Whether in or out of an IMF program; MOF resort to cash controls; Extent of expenditure arrears.			Andrews,2010 Allen,2009
Resource availability (1) Positive, or	Commitment to predictability, sustainability and effectiveness of expenditure management	Tax as % of GDP Access to capital market? Degree of donor support, especially budget support			Tommassi,2009

Describe factor	Describe how the factor impacts PFM reform (positive or negative)	Indicator/indicators to assess impact	How important is the factor for reform: (High/med/low)	How relevant for this country? (High/med/low)	Relevant Sources:
	and control reforms.				
Resource availability (2) Negative "Resource curse"	Scale of revenues from external sources and natural resources may lead to weak and fragmented PFM governance	% of revenues derived from trade and nat. resources as % of total How transparent the accounting for natural resource receipts? How transparent/timely the flows between managing entity and government accounts?			Andrews, 2010, p.34
	Over reliance on high donor disbursements may encourage dependency	Donor inflows as % of govt. exp., average over 5 year period.			Browne,2010 Allen2010, Andrews,2010
C. Conditioning Factors: social and general governance context					
General perception of governance status	Likelihood resources will be captured; reform progress will be slow	World Bank, Index of corruption; Index of ease of doing business, others?			DFID p.49 Allen, 2010,p.4 Quist,2009
Social stability	Ease of implementing longer run reforms; degree of disruption likely	Incidence of civil unrest; degree of ethnic/religious homogeneity			Dressel and Brumby,2009
Cultural stance towards reform	Willingness and support for change, as indicated by: • Power distance/ risk aversion. • Trust • Task versus Process orientation • Individual or Group dynamic • Time orientation will affect the climate for reform.	Level and frequency of delegated decision making. (Levels and centralization of Procurement) Range and importance of procedural rule sets. (how detailed are financial regs.?) Tolerance of ambiguity. (level of discretion for budget decision –making?) Transparency of results focus. (interest in results-based budgeting?) Timeliness of decision-making (procurement lags? budget passed on time?). Degree of consensus in decision making (mechanisms to discuss reforms used?)			Senior and Felming,2006
Strong external accountability mechanisms	Strength judged by: Civil society groups organized and active in their criticism; Legislative committees strong and functioning, with power to investigate abuse; External Audit active & free from the executive	PRSP process exists; NGOs represented in reform planning? No. of times committees meet, no. of cautions issued; Speed of audit reports; degree of follow-up (PEFA indicators?)			Helger and Aga, 2007 Andrews,2010 Dressel and Brumby,2009

Describe factor	Describe how the factor impacts PFM reform (positive or negative)	Indicator/indicators to assess impact	How important is the factor for reform: (High/med/low)	How relevant for this country? (High/med/low)	Relevant Sources:
	Power of mass media: - freedom of press - degree to which media free from government	Index of press freedom No. of non-government TV channels Degree to which government vets internet			
Degree to which "informal" procedures prevail over formal procedures	Insofar as PFM reforms tend to address the formal system, and strengthen it, this will be undermined by strong informal systems that will resist this change.	Proportion of government expenditure within regular budget Extent of "quasi-fiscal operations" Evidence of systematic variances in expenditure during budget execution (See new PEFA PI 2) Evidence of special payment procedures being used, and how prevalent. Degree of under-collection in customs and excise admin.: prevalence of under-invoicing; smuggling; use of ASYCUDA system Transparency of tax expenditures Degree of tax evasion? Evidence this is increasing or decreasing. How well tax evasion is prosecuted Degree to which revealed misconduct in PFM is prosecuted.			Tommassi,2011.
Reform record	Success breeds success: the reforms contemplated should be realistic in terms of past experience and their relationship to other on-going reforms.	Record of PFM reforms: good/bad? No. of on-going reforms in same or related area? No. of which are compatible? Length of reform commitment by the present government?			DFID 2001, p.42 Tommassi, 2010
Colonial heritage	Some systems more centralized than others, give MOF more power in directing reform; Degree of pol. engagement and oversight has historical roots.	Anglophone/ francophone/ soviet/other			Andrews 2010
Degree of fiscal development	The strength of the "fiscal state", or the degree to which taxes are collected from the popn., enhances governance and PFM	% of taxes from non-mineral, non external sources			Andrews,2010, p.37
D. Conditioning Factors: technological and capacity context					
Depth of local labor market	Reflects how severe the	Availability of graduates as % of workforce:			Allen, 2010

Describe factor	Describe how the factor impacts PFM reform (positive or negative)	Indicator/indicators to assess impact	How important is the factor for reform: (High/med/low)	How relevant for this country? (High/med/low)	Relevant Sources:
	supply constraint might be for HR required for reform	-Locally qualified -Internationally qualified Availability of professionals/financial expertise -No of registered accountants locally qualified -No of registered accountants internationally qualified			Bergmann, p.13
Degree of power of the public sector TUs	Reflects degree of flexibility in wages/hiring policies that impact the supply of HR required for reform	Percentage of public employees unionized No. of strikes in the last 5 years. No of incidents of other industrial action or labor disputes			Tommassi, 2011
Country's education/training capacity	Potential for training/retraining to supplement HR skills	No. universities offering courses in financial skills No of colleges/training centers offering relevant courses: -outside government -internal to government Degree to which qualification is internationally accredited: -university degrees -professional certification			Allen,2010,p.5; Dressel and Brumby, 2009
Public Administration Management and leadership capability	Even if political leadership is strong, there is a need for a cadre of senior officials willing to champion, lead and manage reforms	No. of graduates in top civil service grades: -locally qualified -internationally qualified Degree of which bureaucrats are depoliticized: no of political appointees in top civil service grades			Hedger and Aga, 2007 Browne, 2010, p.10 DFID 2001, pp. 50ff Allen 2010
Human Resource Management System	Provides complementary incentives to facilitate reform effort	Size of Private/Public Sector income gap. Size of post holder skills gap. Training/retraining is a part of regular career development?			Dressel and Brumby, 2009
Stability of bureaucrats	Given time required by reform, some stability in the reform internal leadership/management is required	Do HR rules encourage rotation of top staff? Degree of turnover of top staff (average time on post)? Degree of concentration of reform in a few individuals?			Dressel and Brumby, 2009
Degree of ICT skills/computer literacy	Many reforms require IT skills, but scarcity is often a constraint on the success of reform	No. of relevant people with required IT skills			Bergmann & Bietenhader, 2010.

C. Chapter IX: Assessing Reform Risks at the Institutional and Organizational Levels

Summary: *This chapter offers a solution to assessing risks to PFM reforms arising from nontechnical factors that operate at the lower institutional and organizational levels of the PFM system. It is based on Andrews' "three As" methodology, determining the room for reform in organizations. Specific attention is focused on the leadership roles of the MOF and the managers of the receiving ministries in the reform process. The approach develops questionnaires around the "three As" to structure the relevant factors that influence the scope for change, and assigns an estimate of the risks they pose to reform. This analysis, combined with the risk analysis of top level conditioning factors, allows assessment of the overall risk environment faced by different reform actions. This prepares the way for a risk-based approach to reform sequencing decisions that also takes into account some key characteristics of reform actions.*

An Approach to Assessing Risks From External Factors at the Lower Level

206. **Apart from risks to reform that arise from the general political economy of a country; there are also important risks that arise at a lower level**. In the previous chapter it was argued that the first and perhaps most fundamental decision, of whether to engage or not engage in a reform program, could be addressed by assessing the risk impact at the highest level, from the "conditioning factors", that describe the general political economy faced by reform. In cases where engagement is indicated and two dimensions of the reform design have been largely settled—i.e., what is technically required has been agreed, and where the need for reform has been "sold" to the authorities so the demand for change exists—the question is how to decide on the feasibility of different reform actions as a way of sequencing them. Deciding between reform options requires accommodating the wide range of nontechnical factors indicated in the lower two tiers of the three-tier framework previously outlined: those covering institutional and organizational characteristics.

207. **A choice has to be made about the analytical framework to employ in assessing risks at the lower levels.** Unfortunately, while the change management literature provides many insights into the factors that are important in ensuring successful changes in institutions, there are many competing analytical frameworks on offer.[101] Although their terminology can sometimes confuse, fortunately their content, as well as the frameworks themselves, exhibit some evident overlap. A useful way of organizing these factors is to structure them around the three "A"s suggested by Andrews (2008)—*Ability, Authority, and Acceptance*—factors that determine the room for reform in organizations.[102] Schematically the approach is summarized in Figure 9.1 below. His concept of *ability* is centered round the

[101] A useful review of this literature is contained in Fernandez and Rainey, 2006.
[102] Or, in Andrews' terminology, the "reform space". It should be noted that Andrews has developed this approach by synthesizing much of the content in the ever-expanding change management literature.

key concept of capacity.[103] Generally, there is agreement that successful reform requires resources, especially human resources. However, it is recognized that even with adequate resources, there are constraints in converting capacity (the potential to reform) into capability (actual reform action).[104] The two most important constraints center on authority and acceptance. *Authority* describes the institution's formal and informal rules that determine scope for action (or discretion allowed for reform), while *acceptance* describes the incentive structure to undertake that action (i.e., to undertake reform).

Figure 9.1. Reform Space–the Three "A"s

Acceptance

Authority **Ability**

Reform space, at intersection of AAA determines how much can be achieved

Source: Andrews (2008)

208. **The following two sections in this chapter will take each of the lower tiers of external factors in turn**, discuss their importance for PFM reform, and examine the implications of applying this change management approach to better define the content and sequencing of a PFM reform program.

The Institutional Structure of PFM Systems

209. N**early all contributors to the sequencing literature have viewed the input of a strong MOF, acting as the leader and manager of the reform process, as essential to reform success**. However, the power of the MOF in different settings is often determined by the wider institutional structure of a country's PFM system. Although the role of the MOF is usually central to PFM reform, institutionally the span of the PFM system is much wider, also including the legislature, the Cabinet, the line ministries, departments and implementing agencies of government. The power of the MOF to initiate and implement PFM reform is often constrained by this wider institutional setting.

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[103] Capacity in this sense covers a range of issues, including vision, management, and technical and leadership skills.

[104] Dressel and Brumby, 2009, make much of this distinction, stressing that even when capacity is high capability may be low, see discussion in Annex 1. It should also be noted that Morgan (2006) provides a comprehensive framework that divides capability into 19 component parts.

210. **Just as there are many participants in the PFM system responsible for ensuring the deliverables of the system, there are many that can influence the way changes are made to the system**. One important influence arises from the fundamental split between the legislative and executive branches of government. The legislative branch, consisting of the politicians supposedly representing the population's preferences, are typically charged with endorsing policies (including those regarding reforms), authorizing policy actions, and then holding the executive responsible for successfully implementing these policies. However, in some systems, (such as the USA), the legislature is more proactive in formulating policy and, more recently, independent fiscal councils, (like the UK's Office for Budget Responsibility), also may have a role to play.

211. **Within the executive branch that is required to formulate and execute policies, there is a differentiation in roles.** The central policy maker, the Cabinet, approves the aggregate resource mobilization and allocation decisions that underlie the budget based on an analysis developed by the central financial agency, usually the finance ministry. The latter develops the aggregate budget strategy, is required to present budget plans to the legislative branch for approval, and then to oversee the approved budget's successful implementation. The detailed resource planning and actual implementation of policies is generally carried out by decentralized organs of the executive branch, typically organized in line ministries and agencies dealing with specific policy sectors.

212. **Thus in the design of any PFM system there are three main institutional relationships that are central in influencing how successfully the MOF can lead and implement PFM reforms**. These are:

- Between the legislative and the executive branches of government, broadly defining the MOF's role in the system.
- Between the central executive (or Cabinet) and the central finance agency, (usually the Ministry of Finance), defining the degree of MOF authority in driving reforms.
- Between the MOF and the line ministries and their departments and agencies, defining the degree to which the MOF can manage reforms within the system.

In many cases, the way these relationships are designed can constrain rather than support PFM reforms.

Relationship between legislative and executive branches

213. The powers of the legislative branch over the way the PFM system functions vary widely between countries depending on their legal framework, the type of government system operated and the reality of the underlying political control of these institutions. The formal powers granted to the legislature by law with respect to its approval, review, oversight powers, and critically its ability to change the executive's budget proposals, are determined by each country's legal framework often at the level of the constitution. However, it should also be recognized that mechanisms of political control which are not formally defined in the

law may also significantly impact the use and importance of these formal powers. As a consequence of the interplay of both these factors there are large variations in the formal scope of legislative powers and their actual effectiveness.

214. **The powers of the legislative branch vary with the type of government structure.** In some countries the legislative branch can submit its own budget, reflecting its policy priorities, without reference to the executive branch's proposals. In other countries the legislative branch has great powers to vary budget allocations, and hence policy priorities, as long as they do not exceed the total spending limits. In still other countries they can exceed the total limits as long as they bring forth equivalent revenue increases to cover the difference. Such differences reflect deeper institutional design parameters that arise from historically determined checks and balances between institutions. In contrast to this flexibility, there is the large number of countries which follow a parliamentary system of government where the legislative branch has only the power to formally approve or reject the budget, the latter decision typically forcing the government out of power. Differences in powers over the budget policy also are mirrored in powers over changes to the budget system. Consequently, the type of government, and relative powers (formal and informal) between legislative and executive branches, will influence the choice of channels through which PFM reforms will be initiated, the nature of the approval process required, and how reforms will be managed. In so doing, this will necessarily influence the role of the MOF in the reform process.

215. **It should be recognized that for many developing countries, while such formal relationships exist, there are important political influences that may override the formal system with an informal system**. For example, formally the budget should record all resources collected by the government and the different ways they are to be employed during a given period of time. This view of the budget as a policy document that is central to a country's political decision making is one that dominates advanced countries. The reality in LICs is that the government may pursue its policies outside the budget, either through extra-budgetary funds or through public institutions by means of quasi fiscal operations.

216. **Central to the powers of the legislature are decisions on resource allocation.** Implementing policies requires resources. However, resourcing decisions in the government sector are unlike those in the private sector where there is a voluntary exchange of resources, and a strong link between benefits received and resources sacrificed. The people that make public resource allocation decisions are doing so employing resources that are often coerced from the population rather than donated freely. Not surprisingly, there is a constant tension between those making the resource decisions, the policy makers, and the constituent population that pays the taxes and perhaps (or perhaps not) benefits from government spending. Most important there is no one-to-one correspondence between the amount paid by an individual and the benefits derived from government spending. Most political systems work to resolve resource allocation disagreements so as to promote convergence on what

policy makers decide to spend on and what the constituent population wants. But, with the inevitable comprises this requires, divergences remain even in OECD countries.[105]

217. **This often leads to some well recognized defects in public sector resourcing decisions. In some cases there are blatant abuses of power in resourcing decisions**. For example, some political systems there are vast divergences between citizens' demands and resource allocation decisions when resources are captured by political elites or well-connected specific interest groups. Or even cases of outright theft by policy makers who direct resources to benefit themselves and their most influential supporters as a means to perpetuate their political power. The ease with which public resources can be captured often depends on the main sources of revenue generation available. Capture is less problematic when a large part of public revenue is generated from mineral resources or from the operations of specific publicly owned entities, rather than when revenues are raised much more transparently from the population as a whole.

Relationship between Cabinet and MOF

218. **For successful PFM reform ideally the relationship between the Cabinet and the central finance agency**, (particularly that between the Prime Minister and the Minister of Finance), should be fully coordinated. Both should work together to develop a reform strategy and take decisions that underpin the reform. Often this close coordination is not realized. Decisions in Cabinet are made jointly, and typically are subject to extensive bargaining. Coherence in overall reform strategy often depends on the strength of the PM, or the Minister of Finance, to persuade their colleagues and ensure consensus over reforms. In some political situations, such as the case of coalition governments, this becomes even more difficult to achieve. The institutional structure, in which top-level policy decisions are taken, hence the status of the Minister of Finance, also exerts an influence. In parliamentary systems, where decision-making is centralized, and where the Ministry of Finance is undisputedly first among equals, there is potentially a greater possibility of reform coherence and a clearer role for the MOF as the driver of reform. In countries where there is no supreme financial authority, and there are different organizations involved in PFM this becomes more difficult.

219. **Even in parliamentary systems the role of the MOF can be circumscribed in various ways**. Often *the coverage of MOF powers is incomplete*. For example, a large part of government policy may be executed outside the budget and the regular PFM system, through EBFs or quasi-fiscal operations. These are often areas where PFM reforms are most needed, but where the MOF has only indirect supervisory powers. Also, there is often *an institutional dilution in its powers.* A not uncommon arrangement in developing countries is for a

[105] For example, a general problem is the so-called "tragedy of the commons". Due to the "disconnect" between the costs of policies and their benefits, where benefits are private but costs are public, there is a tendency to over spend. In nearly all systems there can easily develop a competition for public resources and a bias to meet the demands of specific groups regardless of cost, allocating more resources in total than is optimal for the society as a whole.

powerful Ministry of Planning/Development, (or perhaps a Donor Coordination Function), to exist alongside the MOF. While the latter is in charge of the recurrent budget, the former is in charge of the capital budget and longer-term development planning, and as such often acts as donors' principal interlocutor. It has already been mentioned that often important extra-budgetary or quasi fiscal activities result in resource allocation decisions that are outside the MOF's control. *Further dilution may arise from devolution.* For a sub-set of countries, typically those with a federal system of government, an additional constraint on the MOF's influence on reform will come from the countervailing power wielded by lower level governments.

220. **There are also likely to be a number of constraints arising from the MOF's internal structure**. For example, policy (e.g., macro, budget, development, etc) functions may be subject to checks and balances from regulatory functions (e.g., treasury management, accounting, and internal audit). Much depends on the cohesion or rivalry between MOF departments. The latter in turn depends on the existence of coordinating (management teams) and integrating functions (working groups) and their effectiveness in allowing the MOF to deliver its mandates. In addition, the MOF like other ministries, (and perhaps more so given its usually elite status), faces the issue of how well human resource management frameworks support the recruitment, retention, and motivation of skilled personnel, (factors that are dealt with in more detail in section 5). In presidential systems the central PFM functions are often fragmented, for example, between a budget office, a Treasury, and a planning and policy office answering directly to the President—all with potential significant inputs to reform formulation and implementation. A consequence of the fragmentation found in such institutional arrangements is that reform objectives and priority reform measures are often vaguely, or partially, articulated. In extreme cases there is a mismatch between reform ambitions (under one office) and the required funding (under another). Without the direct intervention of the President, the resulting success of PFM reforms can be disappointing. In these environments it is the President, or his special appointee, rather than the finance minister who is likely to be the more powerful driver of reform. Thus whatever the system of government, there are likely to be a number of challenges that can seriously impact the sequencing and effectiveness of PFM reform efforts within the MOF, as well as its ability to support reform implementation at the line Ministry level.

Relationship between MOF and line ministries

221. **The PFM relationship of the MOF to the line ministries is generally seen as one of facilitator and watch-dog.** The MOF's mission is to secure required resources for line ministries to implement their sector policies at a level that does not destabilize the economy, while assuring that resources are being used in accordance with budget appropriation. An additional function, although in many countries seldom fully pursued, is that of an oversight

role to also ensure that resources are being employed efficiently and effectively in attaining policy objectives.[106]

222. **Unfortunately, the MOF often faces a number of challenges in fulfilling these core functions**. This is especially the case in developing countries where funding year to year is often difficult to predict with accuracy and planning and budgeting processes do not confront policy choices. As a consequence the MOF's priorities for an appropriate budget balance are sometimes difficult to reconcile with those of the line ministries. This challenge is even more difficult if these differences also reflect: broader political and policy divisions with the executive; unrealistic budget assumptions in respect of revenues, expenditure or financing envelopes; or, resource allocations that do not reflect realistic resource input costs of delivering public goods or services in line with policy objectives and service delivery standards. Specifically, when resources are not forthcoming as planned in the original budget strategy, the MOF may feel compelled to focus on reconciling expenditure with attainable resource levels to ensure overall fiscal discipline.

223. **In anticipation of resourcing difficulties the MOF adopts a number of strategies.** For example, often it operates large contingency funds or reserves, or assumes levels of under-spending on certain resource categories (i.e., capital) that allow scope for substantial re-budgeting efforts during the year and, which when applied, effectively undermine the ministries' official budgets. The severity and unpredictability of the funding shortfall often means that the MOF must also resort to within-year budget cuts. In some countries in periods of unanticipated or severe macro fiscal imbalances the MOF is forced into cash rationing, releasing spending authorizations and cash backing month by month, or even shorter periods, depending on resource availability. In this environment resource allocations are likely be determined by political economy considerations rather than technical ones, with some ministries favored over others. In such cases it is almost impossible for the line ministries to manage their budgets in an efficient way or to fully attain policy implementation—in effect the MOF has taken over the management of their budgets. The scale of the resource gap, and how well the MOF is able to handle this gap, determines how well sector ministries are able to implement their policies[107]. Often, however, the resulting relationship between the MOF and ministries is adversarial and as such can spill over to MOF-led PFM reform initiatives. In this resource-constrained environment the ministry may have little ownership of the formal budget, and in its attempt to deliver services adopt "informal" procedures often in complete disregard of financial regulations. This in turn usually prompts more central control, from the MOF. The result is that the way the PFM system works in practice, shows considerable deviation from that formally described by law and regulation.

[106] The core functions of a finance ministry are comprehensively described in Dressel and Brumby, 2009, Table 1, p.1.

[107] It has also to be recognized that in some countries, where financial management and control has been assigned a low priority, line ministries have exploited this weakness to secure unsustainable budgets and undertake inefficient and ineffective expenditure.

224. **The nature of the relationship developed between the MOF and the ministries has important consequences for PFM reforms.** Typically PFM reforms rely heavily on the cooperation of line ministries for their successful introduction and their operation. If the MOF develops a paternalistic or control mentality towards line ministries this will tend to stifle line ministry management initiative and the development of organizational and PFM skills within line ministries. In turn, this impacts negatively on a range of factors that many writers have emphasized as critical to successful PFM reform: the internal organization of the reform process within institutions; individual incentives of leaders and followers; and the development of adequate skill capacity at the operational level. These will be discussed more fully below.

The relationship between the MOF and other levels of government

225. While concentrating on the MOF's ability to influence the MDAs, it has been noted previously that in some countries lower level governments have significant fiscal independence that may also limit the MOF's powers to influence reform. In such countries sub-national governments are fiscally important, having powers to tax and spend outside the central government's influence. Or alternatively, they are dependent on centrally collected tax shares or non-earmarked transfers that are determined by law, often at the level of the constitution. For some countries this fiscal independence of lower level governments has created severe problems in ensuring national fiscal stability and debt sustainability. In other countries, to satisfy different preferences in resource allocation, and to increase the responsiveness of government to regional needs, there has been a deliberate policy of decentralization in the provision of government services, in some cases involving the transfer of central government administrative units to the lower level government apparatus. The result is often that the central government's MOF is not in charge of the entire country's budget system and hence not in full control of PFM reforms.

226. **The MOF's ability to influence lower level governments will vary between countries and between different types of reform.** For example, in most countries the MOF has the authority to set government-wide standards for reporting and accounting, and through its power over transfers has some leverage to enforce these standards and any reforms it might introduce to improve them. It usually also has scope to influence lower level PFM through the offer standardized services, such as standardized FMIS software, or national training schemes for local officers. However, it must also be recognized there are limits on how far the central government can control the PFM reform agenda at the sub-national level. Moreover, it is also important to recognize that in federal systems PFM reforms have often been first introduced by progressive sub-national governments and then spread to the central government. Recognizing this possibility, some donors have directed their attention to PFM reforms at the sub-national level.

227. **The MOF's role in reform can be analyzed by applying Andrew's methodology.** Employing his three “A”s approach, as outlined in section 1, it is possible to filter the most important factors determining the MOF’s ***authority*** to initiate and lead reforms (centered on

the strength of its leadership role); the factors that influence ***acceptance*** of reform (including the level of support from stakeholders outside the PFM system, within the PFM system, and within the MOF); and the ***ability*** of the MOF to plan and implement reforms, (focusing on its managerial and technical capacity, its current workload and commitments, and available financial resources). Table 9.1 describes these factors, illustrates how they could be ordered, and suggests possible indicators of their importance. The aim is to provide a useful checklist to gauge the importance of each factor for any particular reform action under consideration, based on the likelihood of its impact, and an assessment of that impact's importance.

Table 9.1. Factors Arising from Structure of the PFM System

Describe factor	**Possible Indicators how this factor impacts reform**	**How important for this type of reform, impact:**	**How likely in this country:**
AUTHORITY		High/med./low	High/med./low
Leadership role of MOF in PFM system	Does MOF require approval from legislative branch for proposed reform? If so how likely will it be forthcoming? Formal status of the Minister of Finance in government: presidential vs parliamentary? If latter: majority or coalition? Is the Minister fully behind the reform and/or Is it driven from above (President?) or from below (technocrats)? Stability of minister assured or likely to be changed within reform period?		
Leadership role of the MOF in this reform project	How important is the MOF in resource allocation? For example, what percentage of total government expenditure does it control? Are there other important central government entities that can challenge MOF leadership? Can other important lower level entities challenge MOF leadership? In reform implementation will MOF have operational autonomy, or will this be shared?		
ACCEPTANCE			
Level of support for reform outside PFM system	How broad is the support base? (Cabinet, legislative committees, business community, unions, NGOs)? How far will the proposed reform threaten entrenched informal systems (rent seeking, patronage, power bases, etc)? Level of public discussion of the reform? Are donors as a group supportive or are they divided? Is there a high level steering committee in place?		
Level of support within the PFM system	Do the MDAs support the reform? Is the relationship between MOF and MDAs cooperative or adversarial? (friction from use of cash rationing; powers of virement etc) How much effort has MOF spent explaining the reform to other PFM managers?		
Level of support within the MOF	Is there a designated manager of the reform? How much of his time is dedicated to the reform? Are MOF managers in full or divided support? Degree of rivalry between MOF departments? Degree to which the reform implementation is concentrated in one MOF department? Level of morale within MOF staff?		
Describe factor	Possible Indicators how this factor impacts reform	How important	How likely in

Describe factor	Possible Indicators how this factor impacts reform	How important for this type of reform, impact:	How likely in this country:
ABILITY		for this type of reform?	this country?
MOF Managerial capacity	Has the MOF assigned suitable management resources to implement this reform? How stable will MOF top and middle management be during reform period? What is the MOF's reform record with previous reforms?		
MOF technical capacity	Does the MOF have staff of adequate technical capacity to implement this reform? Will specialist skills be required? Is there adequate outside assistance committed, in TA and training?		
Workload	Is the workload of MOF top and middle management presently excessive? Is the MOF undertaking other parallel reforms? Are there likely to be major work distractions in the period, e.g., due to fiscal stress?		
Financial resources	Is the financing available/adequate for full implementation of the reform? How much required financing is contributed internally and how much from donors? What has been the past experience in mobilizing donor assistance?		

The Internal Organization of PFM Systems

228. Too often it is found that PFM reforms once launched, and even successfully pilot-tested, stumble when it comes to implementing them in the line ministries and their delegated entities. This Quist (2009) has termed the "roll out effort" which he emphasizes is important to understanding reform sequence, and which he views as critical to success. Andrews (2010) has also stressed the problems involved when reforms span many institutions, (or become "de-concentrated"), rather than concentrated in a single central PFM agency. One explanation of this slow-down in implementation is the increased pressure of work on central agencies guiding the reform through an increasing number of entities. However, another, and perhaps more important, explanation lies in the problems encountered in the receiving institutions and in their capacity to internalize reforms. Hence, a useful starting point for analyzing the problems faced in implementing reforms is to understand the range of internal constraints typically encountered by LICs in ministries, departments, and agencies (MDAs). Kiggundu (1989) provides a typical profile of PFM organizations in a developing country, which with some adaptation is presented in Table 9.2 A-C.

Table 9.2A. Top Management Profile

ABILITY	HR capacity	Skills high; educated; articulate, well travelled
	Systems capacity	Weak executive support systems
	Capability (workload)	Extensive extra organizational activities; overworked and often overwhelmed
AUTHORITY	Decision making	Authoritarian, paternalistic, centralized decision-making
	Controls	Top-down centralized control Politicized ; informal controls important e.g., relations with top management colleagues
ACCEPTANCE	Motivation	Long-term opportunistic (are survivors); high job turnover; Often no clear mission or direction, but style of short-term crisis management
	Remuneration	Relatively low for skills compared to private sector
	Morale	Poor; possible reform fatigue

Table 9.2B. Middle management profile

ABILITY	HR capacity	Inadequate management and admin. skills; lack of specific task area knowledge
	Systems capacity	Weak management systems
	Capability (workload)	Understaffed
AUTHORITY	Decision making	Risk adverse, limited willingness to take independent action or initiative
	Controls	Close supervision and little delegation
ACCEPTANCE	Motivation	Low
	Remuneration	Relatively high for skills
	Morale	Low

Table 9.2C. Operating level profile

ABILITY	HR capacity	Low skills, poorly applied
	Systems capacity	High cost operations, low productivity; low levels of training
	Capability (workload)	Overstaffed and underutilized
AUTHORITY	Decision making	Extremely limited, expected to follow detailed regulations
	Controls	Close supervision formally, but in practice lacking
ACCEPTANCE	Motivation	Low
	Remuneration	Low
	Morale	Low

229. **The Andrew's methodology can be usefully applied at this lower level.** Just as in the case of the MOF, it is instructive to take the three central concepts of authority, acceptance and ability, and apply them to Kiggundu's profile of the typical MDA in a developing country context, as shown.

230. ***Ability*, or the potential to undertake reforms, is most obviously constrained in most LICs.** Managerial skills, and skills of all kinds, are limited and are generally difficult to retain and develop due to poor wage scales vis a vis the private sector, and the increasing demands from this sector for these skills as development progresses. Special problems exist at the top management level where one would expect the drive for reform to be critical. While in many ways top managers have the skill capacity, this is often undermined by poor middle management support, and considerably diluted because of overwork, job mobility and top-down centralized controls. However, even with the skills available, it is clear that in most LICs' public institutions do not reach anywhere near their potential "production frontier", i.e., do not translate this actual capacity adequately into potential capability. The reasons are not hard to find.

231. **Part of the problem lies with the *authority structure* within the public sector.** The formal structure in the LIC context is typically hierarchical, with decisions emanating from the center and allowing little discretion for those lower down the chain of command. As a consequence, the top staff in MDAs are viewed as administrators of public funds rather than managers per se. This is aggravated by a reward system typically based on seniority rather than ability, and where those that display ability are usually over burdened by increasing workloads caused by lack of complementary resources, especially the low skill level of subordinate staff.

232. **In this hierarchical system one could expect centrally directed reforms would meet little resistance, i.e., the *acceptance level* would be high.** However, overlaid on the formal authority structure is an informal one. As indicated previously, MOF priorities may

not be aligned with those of the line ministry and the relationship is often adversarial. Top civil servants are often political appointees or associated with a political party, often aspiring to join the political elite.[108] Often a line ministry is captured by its clients, where key ministries pander to their constituent interest groups, often the key industry in their sector or the local politicians. Information asymmetries are very high in the LIC context where reporting is slow and limited, and where reports are seldom audited. In this environment the authority of the central PFM institutions is often undermined, especially when trying to introduce reforms that change the relationship between the line ministry and its key stakeholders.

233. **In any reform of PFM systems there are likely to be gainers and losers and acceptance of the reform will depend critically on the gainers prevailing over the losers**. However, in this calculation it may not be actual gains and losses that are the important factor but perceived gains and losses. For example a top bureaucrat may be expected to gain from a computerization project (ease his workload) or external funding of reforms (increase his budget hence potentially better reward his clientele groups). But much will depend on his perception of these gains. These potential gains may be heavily discounted if there have been several failed reform initiatives in the past (often the case in LICs), and he and his staff are suffering from reform fatigue.[109] Accepting this profile of MDAs' internal organization, it is hard to disagree with Andrews that the "space" for reform can be quite limited in many LICs by the characteristics of the "three As" encountered: ability is limited, authority is diffuse, and acceptance is likely to be very weak. Of all these problems faced in introducing and sustaining reforms at the operational level in a LIC environment, it could be argued that there are certain key elements which appear critical. Or, put another way, in increasing "reform space" three key binding constraints need to be overcome:

- **Key authority factor: Internal leadership.** Leadership is deemed critical in change management. The change management literature stresses how top managerial leaders should persuasively communicate the need and vision for change; facilitate planning of an implementation strategy and develop and approve a course of action for the strategy. This will also require building external support from political overseers and key stakeholders. In the LIC environment this may not be easy since ownership may be lacking. Gauging the importance of this factor requires addressing a number of related issues. Does the drive for reform come from above? Does the minister see eye to eye with the MOF on the need for reform? Are there any mechanisms which allow the ministry management to influence the direction of the reform and respond to the challenges? Did the minister volunteer his ministry or was it selected from above (e.g., PM or president)? Does the top manager see the reform as that of the MOF

[108] Hence the importance of political support at the top level, often stressed as critical in the change management literature.

[109] See Andrews' finding that the time of reform period is important—the longer the time period reforms are sustained then the greater the perceived gains will be.

rather than his ministry? Without support from below, unable to delegate, and stretched to full capacity, how will he make time for the reform workload? Is there a drive for reform from the ministry's stakeholders, the business community, or client base?

- **Key acceptance factor: Management commitment to implement reforms.** The change management paradigm stresses the need to maintain the drive to guide and maintain reform momentum. Top managers are expected to build internal support and overcome resistance, and devote sufficient time and effort to encourage participation of personnel at all levels. In the LIC environment maintaining pressure for reform internally will likely be difficult. A number of questions should be raised: How is the top manager likely to view the reform's impact on his day-to-day work, positively or negatively? How much fiscal stress does he face in day-to- day operations? If the top manager is in fire-fighting mode dealing with uncertain and limited funding for his regular budget activities, how much time is he likely to devote to reform? Or alternatively has he been assigned work commitments outside his organization that are taking up an increasing amount of his time? How much effort will he devote if he is expected to implement other reforms at the same time, or he has just terminated an unsuccessful previous reform? How much time will he devote if he expects to be released soon for training or is due to be rotated as part of regular career development? How much effort will be required to get the reform accepted—is lower level staff likely to be willing to cooperate in reform activities or resist them?
- **Key ability factor: adequate HR resourcing.** It is agreed that the provision of adequate amounts of financial, human and technological resources is essential for most reforms. However, most writers have stressed the importance of adequate HR resources. In this respect it is often not the amounts but the quality of inputs that is critical in the LIC context. Trained and skilled manpower are difficult to find, and there will be resistance to deploying them from other work to bolster the reform effort. The purchase of computer hardware and software tends not to be the binding constraint, but rather the training required in new procedures and the retention of those trained personnel will be critical to sustaining reform. This raises such questions as: Can adequate skilled personnel be found? Can suitable staff for training be identified? How long will it take to train staff, and to internalize and institutionalize new processes? Will outside donors finance and provide the training? Can it be guaranteed that trained staff will be retained for a sufficient period? Can this capacity building be realistically accomplished before shifts in political leadership cause commitment to and support for the reform to dissipate? Is there any latitude to adjust pay scales to attract staff? Is there a parallel on-going or planned public administration reform program that may have a future impact?

234. **Each of these three key factors typically constrains successful reform.** Ensuring these constraints are adequately addressed will have a positive impact on the reform outcome, and is also likely to be cumulative in effect: resolving each factor will contribute to successful reform implementation and help relieve the other constraining factors. While these

prescriptions seem somewhat trite, simply amounting to common sense, in practice most PFM reforms have faced severe obstacles in resolving them. Even a cursory review of reform experience in LICs reveals how often these three constraints have been underestimated. Table 6.3 attempts to summarizing these factors and suggests some possible indicators to assess their importance.

235. **There is a need to develop the questionnaire approach to fully analyze risks at the lower organizational level.** It is proposed by the use of such checklists, as outlined in Figures 9.1 and 9.2; it will be possible to form a fairly comprehensive picture of the risk environment faced by PFM reforms at the institutional and organizational levels. When this is combined with the risk assessment of the top level external factors, as discussed in the previous chapter, it will then be possible to describe the total risk environment faced by any specific PFM reform action in any individual country. It is then proposed that these analyses will be combined in a risk-based approach to reform sequencing decisions that also takes into account some key characteristics of reform actions. It will be remembered that the sequencing literature highlights that different types of reform action will imply different levels of risk of failure, focusing on such technical aspects as: the scope of reform and the degree of complexity involved; the degree of behavior change involved; the time-scale of implementation; and the number of institutions involved, focusing on problems of “roll-out”. To anticipate later arguments these are technical dimensions of reform actions which display different degrees of risk of failure. How these factors should also be taken into account when deciding a reform strategy based on finding the correct balance between risk and reform impact is pursued in detail in Chapter X.

Table 9.3. Some Key Factors Affecting Reform Arising from Internal Organization of PFM Entities

Describe Factor	Possible Indicators How This Factor Impacts Reform	How Important For This Type Of Reform; Impact:	How Likely In This Country:
AUTHORITY		High/med/low	High/med/low
Internal leadership	How committed is the Minister/PS? Did he instigate or volunteer for the reform? Has he assigned a dedicated manager for the reform? How committed are top managers? How much capacity do they have to implement the reforms? Do they have adequate technical skills? Or will they need assistance? Is any planned/available? Presently how high is their workload? Can that be adjusted so they can devote adequate time to the reform? How likely is top management to change during the reform period?		
ACCEPTANCE			
Management incentives	How difficult is it to execute their budgets as planned (indicated by arrears, re-budgeting, etc)? Will the reform, once implemented, reduce or increase management's present workload? How much is the drive for reform viewed as from MOF rather than the minister? Is the regular interaction with the MOF cooperative or hostile? How far will the reform decrease their power/authority in the PFM system? How far will the reform curtail the opportunity for rent seeking and favor trading? How much support/pressure can managers expect from their staff? Are they generally hostile, indifferent, or supportive of the reform effort? How much support/pressure can managers expect from their sector stakeholders (business community, client base, NGOs)?		
ABILITY			
Adequate HR resourcing	Does the MDA have adequate trained staff to operate new reform procedures? Does the reform require any specialist skills presently unavailable? If so, are there opportunities to recruit or re-deploy suitable staff? Can suitable training be identified/financed? Can staff be adequately trained to institutionalize the reforms in a reasonable time frame? What incentives can be provided to staff to retain them once trained?		

D. Chapter X: A Risk-Based Approach to Sequencing PFM Reforms

***Summary*: *A risk-based approach to resolve sequencing decisions is described in this chapter. This recognizes external factors exert different degrees of risk impact on different types of reform actions. At the same time the characteristics of a reform action also influence the risk of success or failure. This Background Paper has highlighted five main risk dimensions of a reform action: the scope, the degree of behavior change involved, the number of institutions covered, the time required for completion, and the reform action's "visibility". Three guiding principles for sequencing are then advanced. First, whenever possible minimize reform risks while maximizing reform impact. Second, match the risk profile of reform actions to the risk environment. Third, allow flexibility in deciding between different sequencing strategies.*

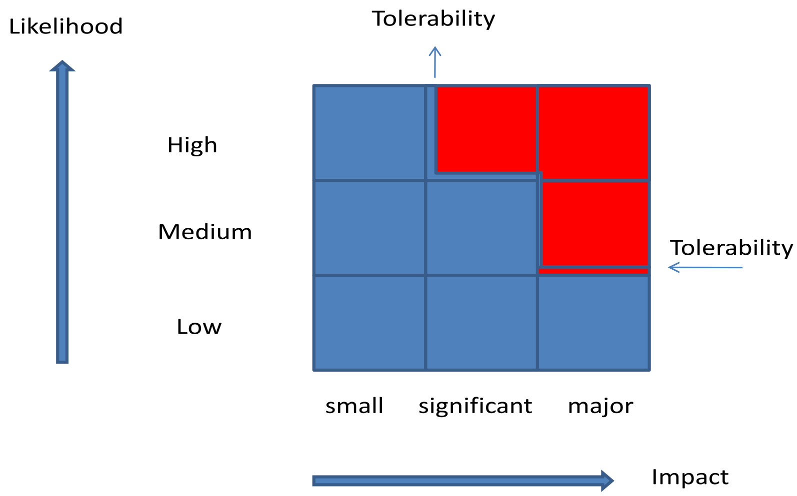
Reform Risk as Criterion for Sequencing Decisions

236. The risk based approach to making sequencing decisions rests on four arguments advanced in previous chapters:

- **First, different sources of risk were divided into three broad categories that may impact the success of PFM reform projects**. Namely: those arising from the general socio-economic environment; those from the way the PFM system is designed; and those from the internal organization of PFM operations. It has been argued that this three tiered framework, once refined through the identification of valid indicators that are empirical tested, could then be employed to provide an assessment of the risks faced by any PFM reform project. Alternatively, this analysis could used positively with the focus on the opportunities where reform is likely to be supported by the task environment, in which case the concept employed would be that of "net risk".
- **Second, it has also been suggested that the three tiers would represent a hierarchy for decision-making on PFM reform.** A country would first be expected to qualify as having an acceptable political economy environment in which the level of risk is not judged so high as to jeopardize attempts to reform the PFM system. Each donor would, of course, choose the degree of risk it would tolerate (i.e., its risk appetite) before engaging in a reform initiative. Once this general risk criterion is passed, the structural characteristics of the PFM system itself would be analyzed from the viewpoint of the risks they represent to specific reform actions being contemplated. If it is felt that the systemic risk to reform posed by PFM institutional arrangements is tolerable, the next stage would be to analyze the risks posed by the internal capacity, the formal and informal rules being applied, and the incentive structure of the organizations which are expected to adopt the planned reforms (as described in Andrews' "three As" approach).
- **Third, to use these, the category of external risk in this way requires some systematic way to order their impact on reform.** Previous chapters offered a preliminary attempt to provide a framework for constructing such a risk register. The register as a statement of risk should, along the lines of Tables 8.1, 9.1 and 9.3,

encompass the cause of the impact, and the relationship which might arise between the impact and the reform objectives (i.e., "cause and consequence"). This requires jointly considering two dimensions of risk: the likelihood the impact will occur and consequences if it does. At its simplest, the likelihood can be assigned three categories: low, medium, high. Similarly the consequences of the impact on reform success can also be assigned to three categories: small, significant, and major. Thus at a minimum a 3x3 matrix should suffice,[110] see matrix below (Figure 10.1). In this way, however simply, a clearly structured process can be provided in which both likelihood and impact are considered for each factor, and can be recorded in a way that facilitates reform design, the identification of priorities, and gives a basis for monitoring reform success.

Figure 10.1. Risk Tolerability Matrix



- **Fourth, this stepwise risk assessment would be combined with active change management to choose a viable reform strategy.** This implies a proactive approach to reform design, including the decisions on sequencing. At any stage in the process, remedial actions could be contemplated to reduce the level of risk encountered, or circumvent them in some way, so as to reduce the negative impact of external factors on the reforms under consideration. In this way change management can be viewed as a way of managing reform risk.

237. **A tolerable level of risk is a relative concept.** In setting priorities in this way it should be noted from Figure 10.1 that it is not the absolute value of an assessed risk which is

[110] Another approach is to assign a score to the consequence and to the likelihood of risk (e.g., 1 to 5), to give a numerical value that can then be combined to provide an overall score. Thus risks can be numerically assessed on a scale from 1 (1x1) to 25 (5x5). For a discussion of scoring see UK Treasury, 2004.

important, but rather whether or not it is regarded as tolerable. How far the exposure of risk is away from "tolerability" is to be determined by those deciding if the reform action can be justified. Certainly a reform project where there are a large number of risk factors assessed in the highly likely/ major impact range (top right hand corner in Figure 10.1) should be re-examined. If possible reform actions should be re-designed to reduce risk to more tolerable levels. If not possible, then the wisdom of proceeding with the reform should be questioned. Unfortunately, it is difficult to generalize in this analytical approach. There can be no off-the-shelf list of threats to a specific PFM reform, but rather risks should be identified (and managed) by those responsible for the project in the specific environment in which it is to be implemented. It is hoped, however, that the checklists offered in this paper could be used to guide the reform manager's identification of risk and to check whether this identification is comprehensive enough. In this way they should offer a useful basis for any modification to reform design that is deemed necessary.

238. **By adopting such a structured risk-based approach donor agencies engaged in financing reform projects can be considered as having fulfilled satisfactory due diligence**. In doing so they should be in a better position to assure their regulators that they have determined the risks that are faced by these projects, and be prepared to disclose the dominant ones as well as the methods they have employed to address them in the project's design. This should mirror the accountability requirements now included in the private sector, and increasingly endorsed by many donors, where an organization is expected to report on the risks it faces, both ongoing and in new projects, the risks it is prepared to accept, and the action necessary to manage those risks it is not prepared to accept. In many ways the above methodology only makes explicit a process that has been implicitly used by many donors in the past.

Making the Risk Based Approach Operational

239. **There are three ways that this approach is made more practically applicable.** Given the large range of possible external factors impacting the success of PFM projects, the approach described above may appear overly burdensome. However, three dimensions of the problem are likely to simplify the task.

240. **First, different types of reform actions are likely to face different degrees of risk impact from the same external factor.** As a consequence not all external factors may be relevant when considering a particular reform action. The success of a particular PFM reform will be influenced to a different degree depending on the characteristics of the reform itself. Reforms can be described in many ways, but often the dimensions are highly correlated. For example, as emphasized by Quist in his analysis of linkages, reforms can be characterized by their scope, whether this is wide or narrow, indicated, say, by the number of individual reform actions implied and their degree of inter-relatedness or linkage. However, this simple categorization is likely to encompass other dimensions that could be considered significant when designing and sequencing reforms.

241. **Secondly, reform characteristics are often correlated.** Reforms that are wide in scope will most likely: involve more than one PFM institution, (or are "de-concentrated"); they are likely to involve new procedures rather than simple modifications to existing ones, hence imply changes in behavior (or are "de facto" reforms); they involve more roll-out effort and thus take longer to complete; and also could tend to be more "visible", hence muster more political support, than narrower reforms. Andrews has suggested these will be more down-stream reforms, i.e., concerned with budget implementation. At the other end of the spectrum will be the extremely narrow reforms. They are likely to be contained in one institution, (i.e., concentrated), will tend to be rule changing rather than behavior changing (i.e., de jure reforms), involve limited roll-out effort, and be faster to complete and because of this could be less "visible" since reform action is more confined in its impact and less politically appealing.[111] This type of reform, Andrews argues, will tend to be more up-stream, concerned with budget preparation. Recognizing key risks will vary with the type of reform action, it may thus be possible to assign average risk assessments by type of reform project as, for example, shown in Figure 10.2 below. This approach is further elaborated in Section 3 below.

Figure 10.2 Examples of Risk Levels from Different Types of PFM Reform in Same External Environment

Examples of common PFM reforms	Scope & complexity of reform	Degree of Behavior change	No. of budget institutions	Time required	Visibility of reform impact	Resulting Degree of overall risk
1.Large taxpayer unit in Inland Revenue Dept.	Low	Low	Low	Low	Low	Low
2.Macroeconomic Policy Unit in MOF	Low	Low	Low	Low	Low	Low
3. Change in budget timetable	Low	Medium	High	Low	Medium	Medium
4.Introduce centralized Internal Audit Unit	Medium	Medium	Low	Medium	Low	Medium
5. Introduce decentralized IA units	Medium	Medium	High	High	Medium	Medium
6. Implement an IFMIS	High	High	High	High	Medium	High
7. Introduce a policy-related program structure for budgeting	High	High	High	High	High	High

242. **Thirdly, different types of external factor are likely to pose different degrees of risk impact depending on the type of reform**. At the same time, each of the three categories of political economy factors—conditioning factors, those arising from institutional design of PFM, and those arising from internal organization—will likely impact the success of PFM reform to a different degree. Again this will narrow the scope of the risk analysis required. For example, generic factors arising from the wider political economy context (as identified through the Environment Scanning Framework analysis) are likely to affect the

[111] Ultimately, to be effective de jure reforms should influence behavior. However, much will depend on the legal tradition of the country. In some countries it is impossible to move in reform without a clear legal basis, in others the executive has much greater leeway in introducing wide reforms without such legal backing.

climate for reform, and as such are likely to exert a diffused impact on all types of reform, but perhaps not critically for any one reform. The political economy factors that arise from the structural characteristics of the PFM system itself are likely to affect more specific types of PFM reform depending on how dependent they are on these design factors. For some reforms these may prove critical constraints, but for others not so critical. The factors that arise from the internal organization of PFM institutions are the most likely to specifically affect reform actions that require to be undertaken in those institutions. It may thus be possible to assign average risk impacts to different groups of factors to be used in comparing different proposed reform actions within the same country context. It should be noted that it is unlikely that specific risks can be addressed in isolation from each other. One risk is likely to have an impact on another. For example, the risk of political instability (a conditioning factor) may impact the power of the Minister of Finance to drive reforms, (a significant PFM structural factor).

Figure 10.3. Risk Impact Associated with Different Categories of External Factors and Type of Reform

Scope of reform action	Conditioning factors	PFM institutional structure factors	Internal PFM organization factors
Narrow	Small	?	Major
Medium	Significant	?	Significant
Wide	Major	?	Small

Employing the Risk Analysis to Determine Reform Strategy

243. **As argued previously, sequencing involves two dimensions**: the timing of reforms and the order in which reform actions are taken. It is envisaged that the risk analysis described above can be employed to assist in making decisions on both dimensions of the sequencing problem.

- **As a filtering device determining timing/pace of reforms.** At the highest level, a review of the conditioning factors and the likely constraints/opportunities available, allows countries to be ranked, with some representing riskier reform environments than others. If there are certain risks that exceed tolerable levels, this is an opportunity to pause in the reforms, or to seek measures to address these major perceived risks. Often this represents a timing problem in sequencing reforms--for example, waiting for a presidential election to be held to determine the continuing commitment to reform, or a fiscal policy issue to be resolved in order to bring required stability to the public finances and create a more stable PFM reform environment. Even if the overall environment displays an acceptable level of risk, in the short-run risks could be considered too high at a lower institutional and organizational levels and to require adjustment in the timing of reform. For example, there may be a need to complete an institutional re-organization, train/recruit suitable staff, or appoint a suitable manager before these lower level risks can be reduced to a tolerable level. This can be considered an important part of change management directed at managing reform risks. Once the risk level is judged tolerable, a more detailed analysis of risks of different reform packages can take place.

- **As a filtering device determining the content of reforms.** From the sequencing literature certain dimensions of reform activities have been identified as critical in implementation. They would also appear to be highly correlated. As suggested above, the wider the scope of reform actions the higher the associated risk to success. "Narrow" reforms, involving one or two specific reform actions—the passing of legislation, or new regulations, the introduction of new procedures in one central institution (i.e., more visible, take less time, are de jure and concentrated)—involve the least risk. "Wide" reforms--involving the introduction of new procedures across a wide range of budgetary institutions, with associated training and changes to IT (i.e., less visible, take more time, are de facto and de-concentrated)—face the highest risk.

244. **Employing the risk analysis, the content of the reform should be tailored to match the assessment of environmental risk.** For example, the two reform dimensions—content and timing—are not independent. While the level of risk will depend crucially on the content of the reform package and the scope of its application, it is always possible to lower risk by a slower implementation of these reforms, i.e., changing the pace of reform. However, change managers should be aware that by changing the content of reform to lower the risks of failure they may at the same time be lowering reform impact. Due to this trade-off they should seek a workable balance between risk and impact.

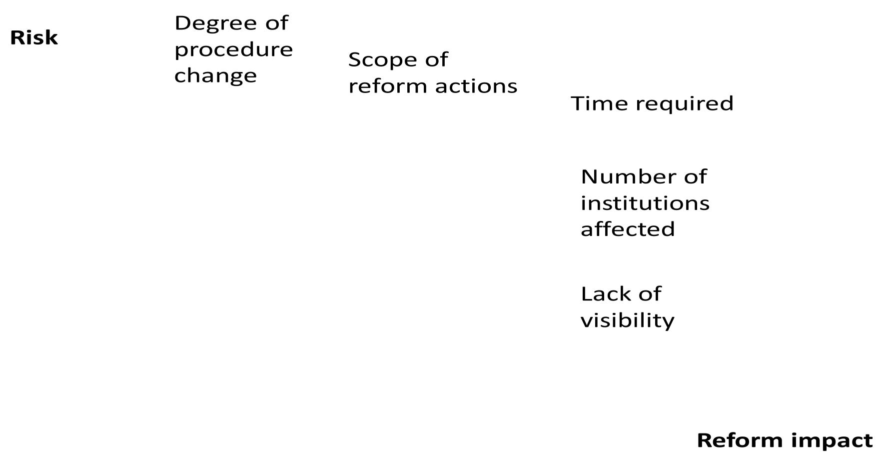
245. **The trade-off between risk and impact is evident when examining the critical dimensions of any reform action.** As suggested, from a review of the literature, it is possible to identify some of the technical dimensions of any reform action that are likely to most influence the risk of failure in implementation. This paper, as indicated in Figure 7.4, concentrates on five main dimensions:

i. *Scope of the reform*, describing the number of required reform actions, their degree of complexity, their interconnections in the PFM system. The wider the scope the greater the risk, but also the greater the likely reform impact.
ii. *Time required to complete the reform actions*. This recognizes that sustaining reforms in a bureaucratic environment is difficult. The longer the implementation period the higher the risk, but at the same time the more major the reform is likely to be.
iii. *Number of institutions involved* (i.e., concentrated or de-concentrated). The greater the number of institutions, the greater the risk but the wider the reach of the reforms.
iv. *The degree to which procedures and behavior must be changed*. Recognizing that the greatest degree of behavior change tends to be associated with more advanced reforms, these are likely to have the greatest impact but the higher risk.
v. *Visibility of reform actions*. From the political economy and change management viewpoints, success in implementation could depend on how easy (or hard) it will

be to demonstrate success, often dictated by the time lag before benefits are seen. The less visible are reforms (i.e., the longer the delay for results to become visible or the more indirectly reform benefits are perceived), are often those with the greater final impact, but suffer the greater risk of failure.

246. **The trade-off between risk and reform impact, as shown schematically in Figure 10.4 below**. It will be noted that the degree of incline of the vectors gives an a priori view of their possible different impacts on reform. That is, the number of institutions affected, the time required, and the scope of reforms are likely to have the greatest impact, while the degree of behavior change less than this, and visibility of reforms the least. It would be useful to empirically test these a priori assumptions. Another implication of this trade-off is that a higher risk level could be justified by higher potential reform benefits. Of course, where reform planners settle on the impact/ risk trade-off will ultimately depend on their level of risk tolerance.

Figure 10.4 The Trade-off Between Reform Impact and Risk



Choosing the Sequence of Reform Actions

247. **The methodology proposed in this paper for choosing the sequence of different reform actions rests on three main guidelines**:

***FIRST:* Wherever possible mitigate risks implied by the type of reform.**

- **Scope of the reform.** Risk can be mitigated by re-designing the reform program, by reducing the number of individual actions, simplifying their complexity by a longer period of phasing in, and first strengthening other supporting PFM processes.
- **Time required to complete the reform actions.** Risk can be mitigated by a slower phasing in of reform actions, and building in “consolidation pauses” in their introduction to allow time for learning on the job.

- **Number of institutions involved.** (i.e., concentrated or de-concentrated). Risk can be mitigated by the often employed pilot approach that allows phasing in the coverage of institutions and by the strategic choice of pilots to demonstrate success (see (v).
- **The degree to which procedures and behavior must be changed**. Choosing sequence between reform actions that require changing rules or changing behavior (de jure or de facto) is not easy, but risk may be mitigated by concentrated on the first category, even though this may lead to negative biases in reform impact.
- **Visibility of reform actions. Risk will be mitigated by choosing high visibility reform actions with** a short time lag to completion. Again the price may be paid in reform impact: biasing reform actions to up-stream, de jure, concentrated, short-run reforms.

SECOND: **Match reform strategy to the risks levels faced.**

248. **Deciding reform strategy on the basis of the risks implied by the reform actions implies resolving this trade-off between reform impact and the level of risk**. To accomplish this requires matching the risks implied by reform actions to the risk environment in which they are to be implemented. *The guiding principle is a high risk reform should only be attempted in a low risk environment.* Applying this guiding principle it is possible to re-examine the different reform strategies encountered in the sequencing literature:[112]

- **Tactical or "low-lying fruit" approach.** This approach will cover reforms narrow in scope, de jure, concentrated in one institution, implementable fast, but most likely narrow in overall PFM impact. This is a low risk approach to reform, and a good strategy in a high risk country, with the qualification that reform impact is likely to be low.
- **Local demand**. While country commitment is important for success, often associated with the visibility of the reform actions, this should not be a blanket endorsement of any reform action. Demanded reforms could be narrow in scope, if country adopts an approach to least disturb the status quo, or could be wide in scope if the country is ambitious to move to more advanced PFM procedures as fast as possible. Depending on the country's risk profile both approaches could be encouraged: narrower reforms for high risk countries (with low reform impact likely) and wider reforms for low risk countries (with likely higher reform impact).
- **Weakest link first**. In this approach chosen reform actions are directed at identified bottlenecks. The nature of the bottleneck will determine the type of reform. It will be remembered that Quist's recommended approach is to concentrate on reforms with high technical impact in removing bottlenecks where the roll-out effect is low. Some bottlenecks can be removed by introduction of simple systems in one central agency (low roll-out), for example with a centralized payroll linking HR data to the payroll is less problematic than the same problem with decentralized payrolls, that involves a number of ministries (high roll-out). Some bottlenecks can be solved by recruiting

[112] These have been identified and discussed in Chapter II.

one or two skilled personnel in a central agency (e.g., introducing a macroeconomic policy unit in the MOF). Other bottlenecks require time-consuming recruitment of suitable personnel and training/retraining programs across a wide spectrum of institutions (e.g., upgrading accountancy standards in government). Some bottlenecks can be removed by introducing procedures that use manual systems or simple Excel solutions, while others require more sophisticated IT solutions and a higher degree of behavior change. The suitability of this approach will depend on the country's risk profile: in a high risk country the approach is viable if the weakest link can be resolved with narrow, concentrated, time efficient reform actions (i.e., low risk reforms); in a low risk country it is viable even if the solution is wide in scope, de-concentrated and time-consuming (i.e., high risk reforms). Again, the likelihood is that reform impact will be greater in the latter than the former.

- **The platform approach.** As indicated this is a strategic approach to reform, that attempts to maximize reform impact by programming reform actions in a sequenced way to support further reforms and is cast in a multi-year framework. In terms of the risk profile, the platform approach is wide in scope, it usually includes both de jure and de facto reforms, in a de-concentrated way, and necessarily allows a longer time period for their completion. Although the higher impact reforms it supports may justify a higher risk tolerance, this approach is probably only viable in low risk countries.

THIRD: **Be prepared to be flexible and mix strategies.**

249. **There is no one universal approach to reform strategy, both between countries and within countries.** In practice, if the previous two design principles are applied—choosing or modifying reform actions to reduce risk, and only attempting a high risk reform in a low risk environment—the end result will most likely be a *mixed sequencing strategy*, combing different elements of previously advocated strategies. For example, in higher risk countries by concentrating reform actions on "low lying fruit" that are also locally demanded. Since it is likely bottlenecks will exist in more than one area, it is possible to choose to address those weakest links which match the country's risk profile: narrow reforms in higher risk countries and wider reforms in lower risk countries. Similarly, the high risk platform approach can be made less risky by allowing re-programming of reform actions on a rolling basis depending on reform experience. Its high risk nature can also be reduced if it is front loaded by low risk reforms, providing a basis for subsequent higher risk reform actions. This could imply, for example, adopting a "low lying fruit" approach in the first platform.

250. **Using this approach it is also possible to revisit the question of how to address on-going PFM reforms that do not fit the newly agreed reform agenda**. One approach is for these on-going reforms to be sub-divided into their constituent reform actions that would then be subject to the same risk analysis described above. If the reviewed specific reform actions were deemed too high risk for the environment, efforts should be made to terminate or delay them (change their sequence). If it is assessed that their risk level is tolerable, and even if they are not judged of highest priority, consideration should then be given to how

specific actions could be incorporated into the proposed reform program. Again the guiding principle in this risk-based approach will be whether the inclusion of these reform components increases the risk level of the overall program to a level that is intolerable, and whether the reform actions can be sufficiently modified to reduce the level of risk to the overall reform program.

251. **The risk based approach to deciding the sequence of reform action is summarized schematically in Figure 10.5.**

Figure 10.5. The Risk Based Approach to Sequencing Reforms

STAGE ONE: DIAGNOSIS OF WHAT IS NEEDED

Compare ?

Lower

STAGE TWO: ANALYSIS OF WHAT IS POSSIBLE

Risk?

Intolerable

Tolerable

Intolerable

Risk?

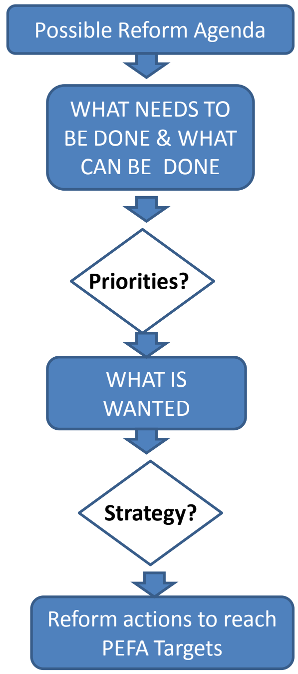
Tolerable

Intolerable

Risk?

Tolerable

STAGE THREE: DIALOGUE TO DECIDE WHAT IS WANTED



IV. CONCLUDING REMARKS

252. **The above analytical framework has been proposed specifically to solve a typical sequencing problem posed by many LICs' general failure to meet a wide range of core PEFA target levels.** Accordingly, the principle objective of developing this analytical framework was to identify the external factors that may have important impacts on PFM reform designed to reach "core" levels, and to assess the risk they pose to successful reform implementation. Once this risk level is determined the approach would be used to match the risk profiles of planned reform actions to the environment in which they are to be introduced. In this way it is possible to come to practical decisions for sequencing reform actions in environments where PFM systems widely fail to meet core functionality. However, quite obviously, this methodology can more generally apply to sequencing decisions beyond the core. Indeed, this risk-based approach to reform design could be used more widely in three main ways: *The first is as a diagnostic tool* by allowing a better understanding of how external factors impact reform actions and so fine-tune the design of reform actions and better determine their sequencing. *The second* is that once reform actions are identified, whether within or beyond the core, it can help improve the design of the overall reform strategy. *The third* is it can be used as a tool to manage risks implied by specific types of PFM reform.

253. **As an aid in the choice of suitable reform actions within a given environment this methodology most probably only makes explicit the risk analysis that in practice is normally carried out implicitly**. It is clear that this methodology requires further refinement. Empirical investigation of PFM reforms could be used to identify the most

important factors determining success or failure, discover how they are **interrelated**, with an aim to reduce the number of indicators required for this analysis. Once the key indicators have been identified, then an agreed scoring system could be constructed that allows some standardization in rating the degree of risk to, and the impact of that risk on, specific PFM reforms. This would allow cross country comparisons of reform experience and, more importantly, assist in determining general recommendations for reform design, including sequencing. As with the PEFA instrument, the approach could be used by the authorities in the form of a self-assessment, jointly in co-operation with development partners, or as part of an analysis of the task environment for a development partner or other stakeholders interested in PFM reforms.

254. **As an aid in improving reform strategy, the methodology will assist generally in matching risks associated with different reform actions to the risks inherent in the reform environment**. It is envisaged that parallel work in identifying technical PFM weaknesses, for example, through the use of the PEFA indicators, should also **allow** the identification of required areas of reform outside core level functionality.[113] To address these weaknesses various reform interventions will suggest themselves. It is argued that these reform initiatives "beyond the core" will also differ in important technical dimensions, and consequently each will have a different risk profile. These risk profiles should be the subject of further empirical verification, to establish how success in PFM reforms differs with respect to the technical dimensions of reform actions. The risk analysis provided by the above methodology could then be used as a filtering device in reviewing alternative reform proposals, their proposed sequencing, and assessing the likelihood of achieving the desired reform outputs and outcomes in country specific risk environments. As argued above, the guiding principles in choosing a reform strategy, within or beyond the core, should be: to mitigate risks whenever possible; to match low risk reform actions to high risk environments and vice versa; and be prepared to be flexible and mix strategies.

255. **As an aid in managing identified risks, the methodology allows a further degree of flexibility in improving reform design.** When the risk analysis is undertaken questions are likely to arise over the next steps once risks have been identified. An obvious next step is to determine a strategy towards those external non-technical **elements** that are felt to pose either too much of a threat to the proposed reform (or alternatively which are considered supportive of reform). This aspect, not much emphasized in the literature, should pose questions such as: What, if any, actions would counter perceived risk or bolster supportive reform activities? How feasible are they and when do they need to be undertaken? How long would they take to complete and at what cost? If the cost is too high should the reforms wait, or be modified, or should other less ambitious reforms be selected? In this way the risk analysis becomes a risk management tool, and one which has a proactive role in determining the sequencing of reforms.

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[113] The first step of this work has been carried out by D. Tommasi, May 2011, revised April 2012. Beyond the basics PEFA targets are indirectly indicated once basic target scores are identified.

256. **At the same time it should be recognized the approach would be more practical if grounded in further empirical research.** A strategic review of sequencing PFM reforms should be undertaken, based on case studies, to determine what has worked and what has failed and the reasons why. The review should focus on the dimensions of risk posed by each reform, as indicated previously, as well as the risk/opportunities environment in which they were implemented. While there have been some extensive reviews of **individual** PFM reforms, there has not been a comprehensive review focused specifically on sequencing and laying out the empirical evidence on what has influenced success or failure. The strategic review should clarify how reform actions were chosen and what determined the pace of reforms. In this regard it may be productive to focus on the role of PEFA in setting the reform agenda and the influence of change management capacity in implementation should be examined. This strategic review should also focus on an empirical examination of nontechnical factors that have influenced reform. This paper has offered a checklist of such factors and possible indicators, many of which are likely to be highly correlated. An empirical analysis should be able to reduce the number of significant indicators and use this sub-set of indicators to classify different countries by their risk profile and also within the sub-set examine individual indicators' association with reform success. Similarly, this paper has offered prototype questionnaires for analyzing non-technical influences at the institutional and organizational levels. Their usefulness should be assessed, and their format further refined, through testing in the field.

Annex to Chapter VI : Sequencing Program/Performance Budgeting Reforms

This Annex is presented for indicative purposes, and in no way should be interpreted as a step-by-step guide to implementation. Rather it attempts to identify the order of the various steps that should be taken when attempting this reform and in so doing gives a rough estimate of the time-line for its completion.

A. Objective: Improving the Program Structure and Program Budgeting Procedures

● ***Preparatory Phase***

1. **Institutionalize the budget reform process.** Minister of Finance establishes a Steering Committee; recruits members of the Budget Reform Unit as soon as practicable; establishes its terms of reference; and has its work plan approved by the Steering Committee.
2. **Development and agreement of a Briefing Note within the MOF on how the budget system is to be developed.** It should explain in depth the reasons for strengthening ministry business plans and why this will necessitate at the same time introducing a new program structure. This would enumerate the benefits for line ministries (LMs). It should present preliminary guidance on preparing LM strategic plans and for introducing a new program structure, methodological issues, the future use of program budgeting, the new role and responsibilities of the reform unit, and a detailed implementation path. The note should be circulated to all line LMs for comment and then forwarded to the Cabinet and any relevant legislative committee for comment and endorsement. The Note should be agreed in time for the next budget round. The External Auditor should be asked for an opinion on the Note.

● ***Phase One: Start-up – to end T +1***

Preparatory work in reformulating the budget classifications.

* By June/July year T, preparation by the MOF of a new classification (chart of accounts), agreed with Pilot LMs, to be used in the T+1 budget classification.

* Agreement on level of broad-banding of standard codes used in T+1 draft budget. Pre-budget circular prepared to inform LMs of this change.

* Cabinet Agreement on rules of LM flexibility in allocating within standard codes for pilot LMs, with legislative amendment agreed.

* Any required programming undertaken for the FMIS.

* Budget circular for T+2 to request program-based budget estimates for pilot LMs and their budgets presented for approval on this basis.

The MOF would initiate the development of program budgeting pilots in at most three LMs.

* Three volunteer LMs are selected. These pilot LMs should have the most well developed business plans, and preferably should have diverse functions.

The selected LMs should be requested to form internal LM working groups in which MOF members of the MOF's reform unit would participate. The task of the working groups would be to agree a LM strategic plan and to develop an appropriate matching LM program budget aligned to the main policy objectives as indicated in its strategic plan. Outputs would be specified for the appropriate levels of programs, sub-programs and activities/projects, and indicators agreed.

The working groups should incorporate both operational staff of the LM, as well as policy staff responsible for the main policy areas of the LM, and important program/project managers. This is needed because program budgeting should connect the policy agenda of a LM to the costing of its activities. The working groups should present their outputs within six months.

* The financial staff of the LM (accountant and budget analyst if any) with the help of the reform unit would cost the identified programs on the basis costs indicated by the common input classification, and agree this program structure with LM management.

* In addition, the working groups should agree a simple explanatory text to clarify LM policies, programs and targeted outputs. This document should serve as a prototype LM budget document, which would present its budget on a program oriented rather than line-item oriented format.

* These pilot LM budgets should be circulated for comments to other LMs and presented for discussion to the Cabinet and legislative committees in Parliament. The submission should be accompanied by a note produced by the reform unit indicating the main lessons learned during the pilots.

- ***Phase 2: Expansion - Duration Two Years to end T+3***

This phase will entail:

1. The reform unit updating its Briefing Note and incorporating any methodological guidance learned from the previous year's pilots. A step-by-step manual should be developed to facilitate an expansion of the pilot to all LMs.

2. Expanding the budget preparation pilot with a view to moving all the LMs to new format program budgets at the same time.

An approach whereby individual line LMs move to program budgeting individually places strains on overall budget management. The aim of the pilots will be to define program structures, cost programs; identify related outputs; and produce an explanatory LM budget document.

The MOF should assign staff to all LM working groups, which should present their outputs and pilot findings at the end of their pilot to the reform unit. The pilot budgets should be presented to the Cabinet and legislative committee, to ensure adequate quality of the various products. Learning from the pilot phase, LMs will adapt their program structures, which are likely to evolve in the following years.

3. **When implementing the pilot for three years the first year (T+1) is more difficult as it must follow the normal budget preparation process.** Also the reform unit will need to provide the working groups with special guidelines for estimating the out-year program costs. A second element of the pilots is to monitor program implementation of the ongoing budget, first on a quarterly, and then on a monthly basis.

4. **In the second year of this phase, the MOF should provide a parallel budget circular for preparation of a program budget for all line LMs and agencies.** All pilot LMs should now be ready to prepare three year program budgets (for next year and two future years) in line with their business plans and start monitoring program implementation by use of agreed output indicators. The program budgets should be sent along with the annual budget for information, and conform to the regular time-table of budget preparation.

● ***Phase 3: Evaluation - Duration 3 months***

The reform unit would prepare an Evaluation Document which details the progress made with the program budgeting introduction. All remaining issues and problems should be identified and solutions suggested. The report should advise the Minister of Finance whether to start full implementation in year four or wait until year five. This would depend mostly on the success in building capacity in the LMs.

● ***Phase 4: Full implementation – either one or two years***

If full implementation is not judged prudent in the fourth year, a “calibration year” will precede the year of full implementation. In the year of full implementation the old budget presentation would be discarded and the new format introduced.

That is, if this sequencing is followed, this reform will minimally take between 5-6 years.

B. Objective: Moving to Performance Budgeting

Key implementation stages:

● ***Phase One : Start Up T+2 to T+3***

In the first year of this stage T+2 the reform unit should prepare a note on the payment, control, audit and reporting processes envisaged when moving towards performance budgeting. This note would be sent for comments to all LMs, the Cabinet and the relevant legislative committees. The External Auditor should be asked for an opinion on the envisaged processes.

This would define the benchmark levels of competence of LMs' core financial management capacity, covering the areas indicated above. This would also determine the degree of flexibility that will be allowed, involving such elements as discussed previously.

2. The Reform Unit will rate all pilot LMs against these competence benchmarks and make a recommendation to the Minister of Finance on which LMs are to be allowed to prepare their 2012 budgets to be implemented under new flexible rules.

3. The Reform Unit will then work with the LMs to agree performance targets based on their output indicators, and agree an annual reporting format for these targets that will be presented with their budget.

4. In budget year T+3, the pilot LMs selected will prepare and implement their budgets under new flexible rules, of course, still within MOF guidelines and hard budget ceilings. The Reform Unit would prepare an Evaluation Document which details the progress made with the introduction of the new system of program budgeting. All remaining issues and problems should be identified and solutions suggested. The report should advise the Minister of Finance whether to continue with the system or not, any changes that need to be made, and if generally positive, which LMs will be selected for the next phase.

● ***Phase two: Progressive roll out in the next 2-3 years.***

That is, the total move to a program-based performance management regime following this sequence would take minimally at least 7-9 years.

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