INTERNATIONAL MONETARY FUND

Fiscal Policy Response to Scaled-Up Aid: Strengthening Public Financial Management

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(In consultation with other departments)

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ABBREVIATIONS AND ACRONYMS

AAP	Assessments and Action Plan
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
CPIA	Country Policy and Institutional Assessment
DAC	Development Assistance Committee (OECD)
DFID	Department for International Development
EBF	Extrabudgetary Fund
GDDS	General Data Dissemination System
GFSM 2001	Government Finance Statistics Manual 2001
HIPC	Heavily Indebted Poor Countries
IFI	International Financial Institution
IFMIS	Integrated Financial Management Information System
LIC	Low-Income Country
MDG	Millennium Development Goal
MoF	Ministry of Finance
MoP	Ministry of Planning
MTBF	Medium-Term Budgetary Framework
MTEF	Medium-Term Expenditure Framework
MTF	Medium-Term Framework
MTFF	Medium-Term Fiscal Framework
NDP	National Development Plan
OECD	Organization for Economic Cooperation and Development
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PETS	Public Expenditure Tracking Survey
PFM	Public Financial Management
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
ROSC	Report on the Observance of Standards and Codes
RTAC	Regional Technical Assistance Center
TA	Technical Assistance
UTRAFE	Unidade Técnica de Reforma da Administração Financeira do Estado

EXECUTIVE SUMMARY

Sound fiscal institutions and public financial management (PFM) systems are essential if low-income countries (LICs) are to achieve the goals set out in the Poverty Reduction Strategy Paper (PRSP) and the Millennium Development Goals (MDGs), and benefit from aid scaling up. However, most PFM systems in LICs require substantial upgrading, and there has been mixed success in making improvements in recent years. The paper identifies reform measures that should be given priority in the short term. It also discusses the challenges that LICs are likely to face in designing and implementing an action plan to reform PFM, and the role of the Fund in supporting the reform process.

A first critical area is to establish a coherent and well-integrated approach to strategic planning and budgeting. In addition, countries that have sufficient capacity should be encouraged to develop a medium-term budget framework (MTBF).

A second important area is to build capacity in budget execution and reporting to ensure the efficient, effective, and transparent use of public resources. Such reforms should focus on upgrading the classification of expenditures and revenues and the accounting, internal control, and fiscal reporting systems. Other important areas likely to require attention in the short term are public procurement and payroll management. Steps should also be taken to more fully incorporate donor aid into the budget. To assist the tracking of poverty-reducing expenditures, a gradual move to results-oriented budgeting—emphasizing the outcomes and outputs of government programs—could be considered where the conditions are right.

LICs should prepare a prioritized and well-sequenced action plan for strengthening fiscal institutions and PFM systems, based on these key measures. Such a plan should be grounded in a thorough and up-to-date diagnostic assessment of existing strengths and weaknesses in PFM. It should have the full support and leadership of the authorities, and the backing of donors and other stakeholders. A "platform approach" to reform can be considered in appropriate circumstances.

Medium-term reforms should also be outlined in the action plan. These include strengthening treasury and debt management systems, increasing subnational governments' PFM capacity, linking PFM reforms to broader reforms of the civil service and governance, and strengthening accountability mechanisms, including the national audit authority.

Effective coordination between technical assistance (TA) providers and the authorities is critical to the successful implementation of PFM reforms. In supporting the reform process the Fund should: emphasize the importance of country ownership of the reforms; learn from lessons of the past to use TA more effectively; where appropriate, make effective use of external finance and partnership arrangements with the World Bank and other TA providers; and leverage the resources of staff from Fund headquarters and the Regional Technical Assistance Centers (RTACs).

I. INTRODUCTION

1. **This paper focuses on the need to strengthen fiscal institutions and PFM systems in low-income countries if key public services are to be delivered efficiently and effectively.**[1] This applies both to the 50 percent of such expenditures which on average are financed through domestic resources in LICs, and those financed through overseas aid. Sound and effective PFM systems are important for several reasons: (i) to increase the prospects of achieving fiscal stability and key economic and social priorities, as reflected in the MDGs and the PRSP; (ii) for transparency and accountability reasons—to ensure that the government is held responsible for managing public resources and that donors and taxpayers have access to information about the allocation and use of such funds; and (iii) to reduce the transaction costs of aid-related donor requirements.

2. **The scaling up of aid to LICs is likely to impose additional pressures on PFM systems**. The unpredictability and volatility of aid flows is likely to increase, thus weakening the credibility and effectiveness of the budget process in setting priorities and in allocating and managing resources. Expectations among the international financial institutions (IFIs) and donors that aid will be used more efficiently and productively, and that measures will be taken to improve governance and tackle corruption, may increase. And demands from domestic stakeholders for more transparency and accountability in aid provision and the management of donor-financed projects may also be raised. The international community has recognized PFM as a key element in improving aid effectiveness. The Paris Declaration (2005) includes guidelines for improving the performance of donors and participating countries, including PFM benchmarks.[2]

3. **In many LICs, the absence of an adequate PFM system led donors over time to prefer project financing and off-budget aid delivery.** Indeed, according to a recent survey of 31 LICs, on average only 37 percent of external aid is channeled through country PFM systems.[3] Providing budget support by donors requires a higher level of confidence in a country's PFM systems. Pressures to deliver on scaled-up aid, however, may mean that in many cases, support continues to be delivered outside the budget, with the result that aligning

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[1] Low-income countries, as defined in this paper, comprise the group of 78 PRGF-eligible countries (as of July 2006).

[2] Several of the 12 benchmarks (or indicators) agreed in Paris are relevant to PFM systems, especially (2a) quality of the PFM systems, (2b) quality of the procurement systems, (3) percentage of aid reported in the budget, (5a) use of country PFM systems for disbursing aid, (5b) use of country procurement systems for disbursing aid, and (7) the predictability of aid flows. For each of these indicators a baseline value was measured for 2005, and a target has been set for 2010 representing a significant improvement in performance. See OECD (2006a).

[3] OECD (2006a).

priorities with those in the budget may be affected, and efficient tracking of poverty-reducing expenditures, including those financed through aid, will become harder to achieve.[4]

4. **This paper is structured as follows:** Section II demonstrates that fiscal institutions and PFM systems are still weak in many LICs. Section III describes the measures that could be taken in the short term and medium term to strengthen fiscal institutions and PFM systems so that effective use is made of budgetary resources, including scaled-up aid. Section IV focuses on the challenges—technical and institutional—that LICs are likely to face in designing and implementing an action plan to reform fiscal institutions and PFM systems, and the role that the Fund and donors might play in supporting the reform process through lending activities and TA operations.

II. Weaknesses of Existing PFM Systems in LICs

5. **Many recent diagnostic studies have evaluated the quality of fiscal institutions and PFM in LICs.**[5] The results of these assessments are summarized below.

- *The HIPC-AAP process*, applied to 23 eligible LICs in 2001 and 26 in 2004, provided the first opportunity to undertake periodic PFM assessments aimed at measuring progress over time.[6] Nineteen of the 26 countries were assessed as still requiring substantial upgrading. Budget execution and the ability of countries to track poverty-reducing expenditures were especially weak (Figure 1).[7]

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[4] It is not only donors who may prefer to channel aid outside the budget. Both line ministries and the political leadership may also have an incentive to bypass the national resource allocation process; the former, in order to maintain direct assistance to their programs that avoids scrutiny by the ministry of finance (MoF) and parliament; and the latter, to avoid making difficult trade-offs between competing claims on scarce budgetary resources. See Sulemane (2006).

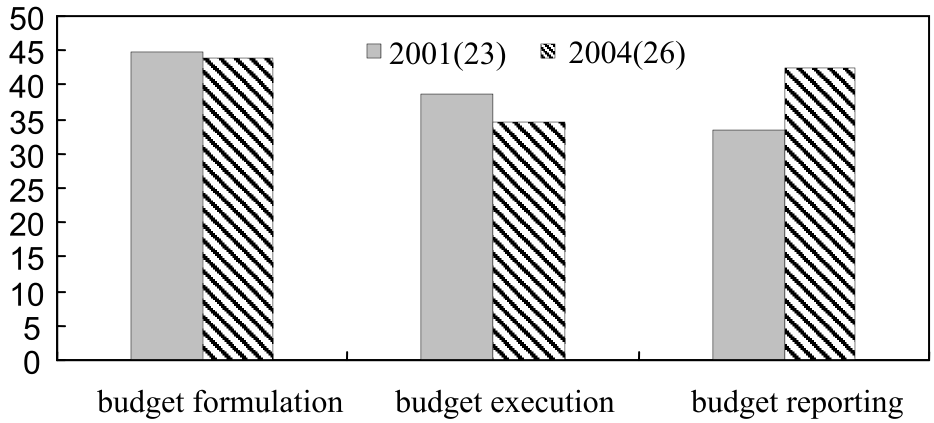
[5] These studies include HIPC Assessments and Action Plans (HIPC-AAP) prepared jointly by the IMF and World Bank on a range of LICs; the IMF's fiscal transparency ROSC; World Bank assessments, including Public Expenditure Reviews (PERs), Public Expenditure Management and Financial Accountability Reports, Country Financial Accountability Assessments (CFAAs), and Country Procurement Assessment Reports (CPARs); and reports prepared by the multi-partner Public Expenditure and Financial Accountability (PEFA) program. For a useful assessment of the available data, see Chapter 6 of the World Bank (2006).

[6] The results of both assessment exercises are summarized in IMF (2006) and World Bank (2005).

[7] Dorotinsky and Floyd (2004) concluded that, while budget formulation has improved in a number of countries, budget execution and accountability are still very weak in the majority. Thus, fewer than one-third of the countries surveyed had budget outturns that were close to the budget as adopted, and 90 percent of African countries surveyed failed to complete final audited accounts within 12 months of the end of the fiscal year, thus rendering meaningful parliamentary oversight impossible.

Figure 1. HIPC AAP: PFM Performance by Key Categories

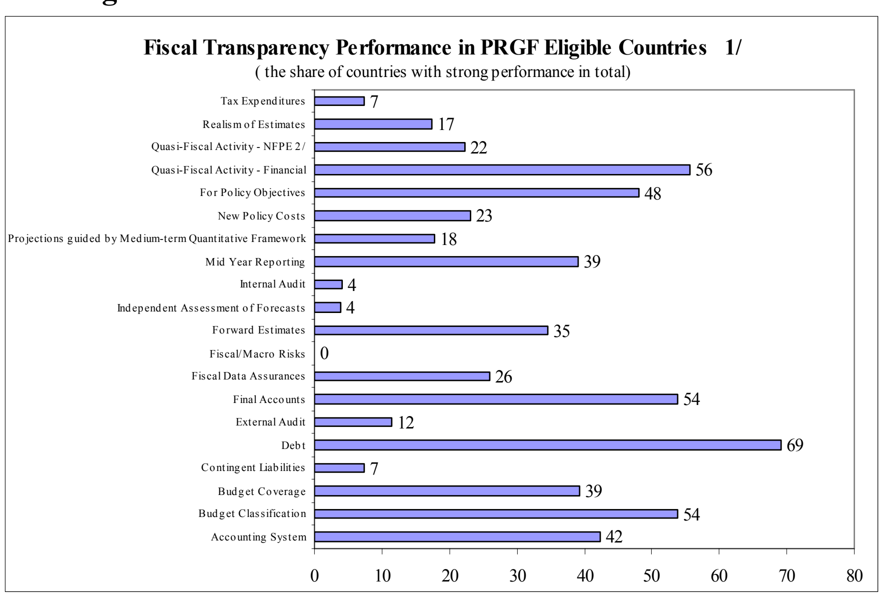
(the number of countries meeting benchmarks in percent of total) 1/



Source: IMF and World Bank estimates.
1/ Total number of assessed countries in each year is given in brackets.

- *The fiscal ROSC assessments* for a sample of 28 PRGF countries suggest that, while in certain areas of fiscal transparency the performance of LICs is not out of line with that of more advanced economies, it is generally weak in many areas—such as a comprehensive and credible budget, and effective audit procedures—that are important in a well-functioning PFM system (Figure 2).

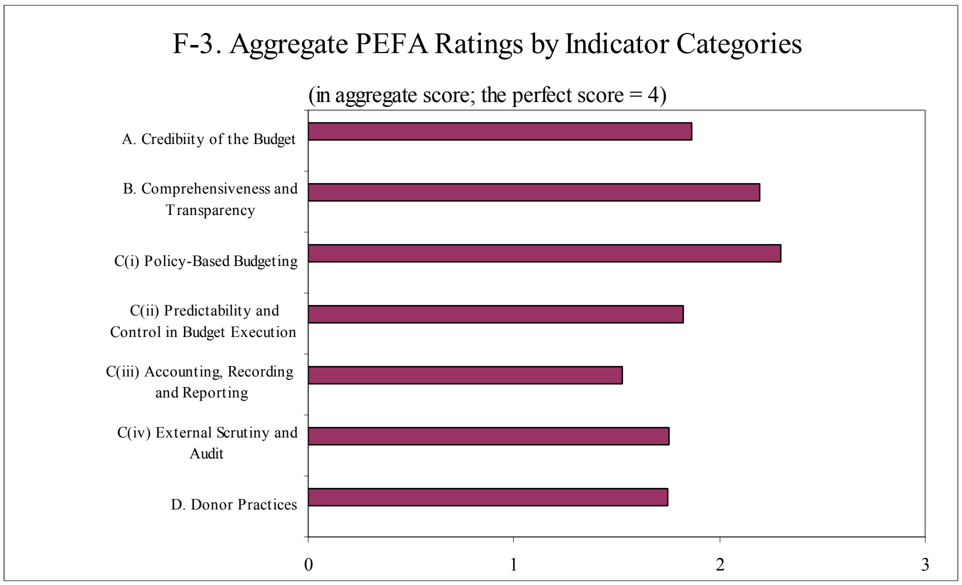
Figure 2. Fiscal ROSC Assessments from 1999 to 2005



Source: IMF estimates.
1/ Based on IMF fiscal ROSC assessments for 28 PRGF-eligible countries between 1999–2005.

- *The PEFA assessments*, which only began in 2005, at present cover a relatively small sample of 12 PRGF-eligible countries, though the coverage is expected to expand quite rapidly. Early results suggest a pattern of relatively poor performance across-the-board in key areas of budget preparation and execution, with a median score of around 2.0 against the international good practice standard of 4.0 (Figure 3).[8]

Figure 3. PEFA Assessments Undertaken During 2005–2006



Source: The PEFA Secretariat, World Bank

- *The World Bank's Country Policy and Institutional Assessment (CPIA) ratings*—based on an assessment of whether the countries concerned have a comprehensive and credible budget, effective financial management of revenues and expenditures, and timely and accurate fiscal reporting—also display a picture of relatively poor performance. Of 27 countries reviewed in OECD (2006), scoring ranged from 2.0 (weak) to 4.5 (moderately strong) (Figure 4).[9]

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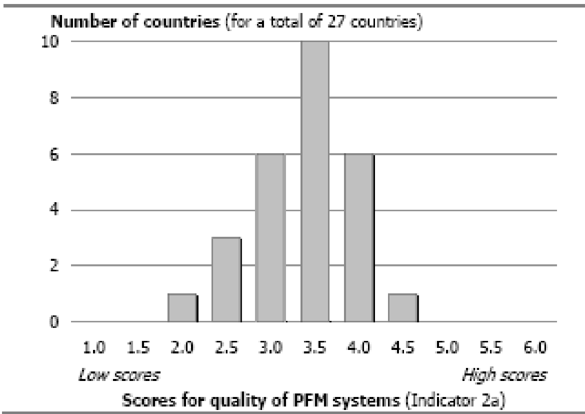
[8] PEFA is a partnership whose members include the World Bank, the IMF, the European Commission, and several bilateral donors. The PEFA framework incorporates a four-point rating system (A to D, with intermediate ratings also permitted) compared to the three-point scale (A, B, C) used for the HIPC-AAP assessments. See PEFA Secretariat (2005) and its website, www.pefa.org, for further information.

[9] OECD (2006b).

Figure 4. CPIA: Quality of Partner Country PFM Systems in 2005[10]



Score	Label
1.0	Very Weak (PFM systems)
2.0	Weak
3.0	Moderately weak
4.0	Moderately strong
5.0	Strong
6.0	Very strong

Source: World Bank Country Policy and Institutional Assessment (CPIA sub-component 13), 2005

- *Recent evaluations of the Fund's TA activities in LICs reached a similar conclusion.* One evaluation concluded that in many countries, budget plans were based on unrealistic assumptions, were not comprehensive, and lacked a medium-term focus; accounting and payments systems and other areas of budget execution were weak; budgetary institutions were fragmented; and broader institutional problems such as weak legislative oversight and poor accountability of senior budget officials were common.[11] In some countries reviewed, civil conflict had added to these problems.

6. **The broad conclusion is that, despite sustained efforts in many countries—supported by the IFIs and donors—to undertake PFM reforms, progress has been uneven.** A recent World Bank study suggests that countries such as Ghana, Mali, Mozambique, and Uganda have shown capacity for quite rapid improvement in their PFM systems, especially those that have promoted reforms in budget management and given incentives to civil servants for better performance.[12] However, reform of PFM systems in countries that have been affected by corruption, extended civil conflict, and the evasion of formal rules and external scrutiny has stagnated. Another important lesson is that countries have not always prepared an action plan for reform that is well-structured and realistic about the prioritization and phasing of reform measures, given the countries' limited capacity.

III. Strengthening Key Elements of PFM

7. **Improving expenditure efficiency calls for strengthening fiscal institutions, including PFM systems.** As noted, most PFM systems in LICs require substantial

[10] OECD (2006b).

[11] See IMF (2004), which reviewed FAD's TA operations in sub-Saharan Africa.

[12] World Bank (2006).

upgrading. Weaknesses in PFM can result in waste of funds on low-priority programs and activities and diversion of funds through corruption; weak budget execution caused by cash shortages induced by aid volatility; inefficient delivery of public services; unsustainable spending (for example, on capital assets that will be underutilized or whose life expectancy will be reduced because of inadequate operational and maintenance budgets); and projects that have been started with donor support but cannot be sustained. The PFM measures described below are those judged to be especially important in the short term. Work on implementing some of these measures, however, will need to be sustained over a period of years if they are to become fully effective.

8. **Countries that are emerging from conflicts or have suffered major disasters face special challenges in strengthening their fiscal institutions**.[13] These countries have generally received large injections of aid resources which their PFM systems are often not able to cope with, either due to the logistics of handling sudden increase in inflows of aid, or because institutions and PFM capacities have been significantly weakened and cannot respond adequately or meet donor expectations. In the experience of many post-conflict or disaster-affected countries, there is often a sudden influx of foreign experts to work alongside national staff or sometimes even run the central fiscal institutions until national staff can take over. In such cases, both the focus of PFM reforms and the perception of where the main weaknesses are concentrated may be different from what has been described above. These issues are highlighted in Box 1.

Overall strategic planning

9. **A coherent approach to economic and social planning, and a structured and cohesive set of planning instruments is required** to ensure consistency in policy priorities both within the government (and across different sectors) and between the government and donors. The strategic planning process should be anchored in the budget process to help the government achieve its medium- and long-term policy objectives, as defined in the PRSP and MDGs. Among other measures, this could include strengthening the relationship between the planning and budgeting cycles (and between the planning and finance ministries, where these are separate organizations), strengthening the role of the cabinet in strategic decision making, closer integration of the recurrent and development budgets, and increasing the coverage of donor-funded development projects in the budget.

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[13] See Gupta and others (2005) and Schiavo-Campo (2007) for more details.

Box 1. Strengthening PFM in Post-Conflict and Disaster Affected Countries[1]

Post-conflict countries provide an insight into the challenges and opportunities that scaling-up aid on a wider scale may pose to their PFM systems. The countries concerned may also display special circumstances that affect PFM issues and priorities, such as:

- **Greater need to consider PFM reforms within the context of any emerging political and constitutional debates.** Post-conflict countries are often in a state of political and constitutional flux. Early PFM reforms may favor greater centralization of control to increase efficiency, whereas political forces may pull in the opposite direction.
- **Potential loss of physical and institutional infrastructure can greatly increase the capacity constraint faced by the recipient country.** Post-conflict countries have often experienced some form of regime change, and key government positions may be filled by international experts, diluting local capacity.
- **Large off-budget donor expenditures can increase the volatility of aid revenues as the emergency phase recedes.** Changes in donor priorities and withdrawal of support can lead to large projects suddenly being brought on-budget. In the short run, this can crowd out other budget items and lead to ad hoc changes in appropriations.
- **The right balance must be struck between slow, thorough approaches and fast, pragmatic solutions.** In emergency situations, it becomes harder to undertake rigorous reviews to tackle fundamental issues and a strategic approach to planning and sequencing PFM reforms.
- **Post-conflict countries often have a larger, concentrated donor presence, which can facilitate coordination of priorities and systems, if well managed.**

PFM reforms that are likely to require priority attention in post-conflict countries include:

- **Establishing/strengthening the central budgetary institution.**
- **Preparing a credible annual budget with clear and reliable estimates.** The first step in many cases is the formulation of an emergency budget, which is by necessity rapidly constructed and subject to revision.
- **Developing a clear government accounting system** that can track the use of budget appropriations, produce clear reports on outturns, and support the government's financial reporting obligations.
- **Undertaking a review of the legal and regulatory framework** for budget preparation and execution (which may be necessary if regime change leads to rejection of the existing legal framework).
- **Taking initial steps to harmonize the medium-term fiscal and strategic planning framework** so that it transparently shows both donor commitments and planned transfers to the government's budget.

1/ Countries such as Rwanda (1994); Bosnia and Herzegovina (1995); Kosovo (1999); Timor-Leste (1999/2000); Sierra Leone (2000); Afghanistan (2001); DRC (2002); and Iraq (2003) experienced sharp increases in the volume of aid flows following the cessation of periods of conflict. In others, such as Honduras (1998), and Sri Lanka (2004), the international community provided support following devastating natural disasters.

Developing a medium-term approach to budgeting

10. **Comprehensive, reliable and consistent macroeconomic and fiscal projections are essential components of a realistic and achievable medium-term fiscal framework (MTFF),** which can guide the planning and budgeting processes.[14] Implementation of an MTFF has been included as a structural benchmark in several IMF programs. Such a framework requires appropriate technical capacity and competence within the ministry of finance (MoF). To enhance coordination and ensure full benefit from limited human capacity, a macrofiscal unit could be set up within the MoF to spearhead the development of an MTFF.

11. **The traditional one-year time horizon of the typical budget process does not present decision makers within government with a complete picture of the medium-term fiscal consequences of the budget.** This problem can be addressed in more advanced countries by introducing a medium-term expenditure framework (MTEF). An MTEF is a set of projections of government expenditures and revenues over a medium-term period, usually two to four years, in which the projections are rolled forward by one year annually. Such a framework can help align the budget with the government's medium-term planning goals such as the PRSP and progress toward the MDGs.

12. **Designing and implementing an MTEF, however, is a complex and challenging process that needs to be approached cautiously and on a step-by-step basis.** Successful adoption of an MTEF requires inter alia: (i) a capacity for making realistic forecasts of macroeconomic variables over the medium term; (ii) procedures for estimating fiscal developments beyond the current and upcoming fiscal years; (iii) a review of the decision-making processes of government and associated institutional arrangements; and (iv) enhanced coordination between the MoF, the planning ministry, and other central agencies and line ministries through cabinet or cabinet committees. For these reasons, MTEFs have proved difficult to implement in many developing countries: necessary institutional adjustments have not been made and the MTEF has not been fully integrated into the annual budget process.[15] A recent IMF review concluded that developing an MTEF can be effective where circumstances and capacities permit; otherwise, it can be a great consumer of resources and may distract attention from the immediate needs such as improving the annual budget execution process.[16] In many cases in Africa, where the

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[14] See, for example, Heller and others (2006).

[15] In one of the more successful African MTEFs, Uganda, the authorities spent five years establishing a stable MTFF before gradually starting to develop projections for individual sectors. Other countries, such as Tanzania and Rwanda, spent a few years testing the new approach in a few ministries before applying the MTEF to the whole budget. See also case studies of Malawi, South Africa, and Uganda in Simwaka (2006), Fölscher and Cole (2006), and Kuteesa and others (2006).

[16] IMF (2006) and World Bank (2006).

preconditions were not right, the MTEF was introduced prematurely, and has turned out to be largely a paper exercise.[17]

13. **Nevertheless, some LICs that have a functioning MTFF may be able to take the further step of preparing an aggregated form of MTEF** focusing, initially, on developing the capacity to prepare sectoral ceilings and forward estimates, within an aggregate resource envelope ("top-down" budgeting), linked to the planning framework, and used as guidelines for detailed annual budget preparation. This type of higher level (or more aggregated) MTEF is sometimes referred to as MTBF. For countries whose detailed MTEFs have failed, a simplification process should be encouraged.

Strengthening budget execution and reporting

14. **The emphasis should be on building capacity in budget execution and reporting to ensure efficient and effective use of resources and better tracking of poverty-reducing expenditures**.[18] In the short term, countries with low capacity should focus on "getting the basics right"—relatively simple reforms of the kind summarized in Box 2. These include topics such as budget classification, accounting, internal control and fiscal reporting. Such measures will help countries avoid both ad hoc decision making on the allocation of budgetary resources and frequently encountered problems such as expenditure arrears and low quality and untimely fiscal reports.

15. **The maintenance of an adequate and coherent accounting framework is essential to tracking spending, enforcing accountability and meeting donors' fiduciary requirements.** In addition, timely, consistent, and coherent information on revenue and expenditure developments is an important input into the process of planning future budgets. It is important to specify the accounting principles and basis used, and describe exceptions that may apply to particular items.[19] At a minimum, a functioning accounting system should include: (i) regular bank account reconciliation with accounting records; (ii) double-entry accounting procedures, with both general ledger and supporting subsidiary ledgers; (iii) a chart of accounts that facilitates reporting according to the budget presentation;

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[17] Where MTEFs with full activity-based budgeting systems have been introduced, in Ghana and Malawi for instance, these have generated large volumes of detailed information in which the main objective of the MTEF, namely linking policy to budgetary allocations and introducing reliable forward estimates, has been lost.

[18] See Schick (1998), Allen and Tommasi (2001), and Diamond (2006) for more details.

[19] It has been observed that many countries have systems that work on a hybrid accounting basis, with even senior officials not having a full understanding of the framework in use.

Box 2. Short-Term Priorities for PFM Reform

- Ensure that the ministry of finance or central budget authority has adequate control over the fiscal aggregates and that budgetary spending is in line with the approved budget.
- Ensure that the process of preparing the annual budget is comprehensive and coherent, follows a sensible timetable, and is adequately integrated with the priorities-setting process of the national plan and/or PRSP.
- Establish a budget classification, for administrative and economic categories initially, that complies with international good practice.
- Introduce a basic accounting system, with some level of automation, to process receipt and payment transactions, record information, and produce timely fiscal reports reconciled with banking data, at least for the main aggregates.
- Take steps to ensure reasonable cash flow planning and control of spending at key points of the spending chain and at the commitment stage.
- Establish a simple system for recording donor aid commitments and disbursements and tracking poverty-reducing expenditures.
- Ensure that staff manuals on budget preparation and expenditure authorization procedures are in place.

(iv) periodic and timely in-year consolidation of accounts, where accounting is decentralized; (v) maintenance of adequate accounting records; and (vi) preparation of appropriate manuals and training for accounting staff. Accounting information should be comparable between years, and between the approved budget and data on realized expenditures. Any changes in the accounting basis and principles should be clearly specified and necessary adjustments made to ensure that the data are consistent.

16. **Government banking arrangements need strengthening to improve cash management and accounting, and reduce fiduciary risk.** Apart from facilitating cash management and minimizing the cost of financing public expenditure, a consolidated banking arrangement—ideally in the form of a treasury single account—also improves the quality of accounting data through effective and timely bank reconciliation. Care should be taken during scaling up to ensure that the number of bank accounts does not proliferate and further overload the low capacity of systems in LICs to keep track of the increased volume of transactions passing through the banking system. Over time, donors' bank accounts should also be integrated with the treasury's accounts to avoid problems with cash management, and their respective accounting and banking records should be reconciled in a timely manner.

17. **Regular and timely fiscal reporting is necessary to assure donors, policy makers, legislators, and other stakeholders that the government is on track in implementing its annual budget**, whether financed through domestic resources or external aid. While

achieving regular fiscal reporting at the general government level is highly desirable, especially in LICs with significant spending at the subnational level, the main requirement should be for timely and reliable reporting of the central government budget. Although many countries have some form of monthly reporting, the coverage and quality of such reports continue to be weak. While in some cases technical issues need to be addressed, a more frequent constraint is the lack of sufficient political and administrative will to enforce a culture of reporting, and insufficient appreciation, even at the finance minister level, of the relevance and usefulness of regular and timely fiscal reports. To ensure that these fiscal reports/statements are complete, donors should provide full information to the authorities on their planned and actual aid disbursements, whether in cash, in-kind, or by direct disbursement to suppliers, particularly when these are not reported through the treasury.[20]

18. **A sound system of internal control is necessary to provide reasonable assurance that public expenditure is executed in accordance with the approved budget and the established regulatory framework.** The effectiveness of budget execution does not necessarily increase by adding multiple layers of redundant control.[21] What is required is that the control function/task should be clearly articulated and assigned, understood by controllers and consistently applied to all transactions.[22] Given that payroll expenditure forms a very substantial part of public expenditure and crowds out other spending in many LICs, improving payroll control by integrating personnel and payroll data into the budget process, to the extent practicable, should also be given priority.[23]

19. **Weak or inadequate public procurement systems are one of the main sources of corruption.** Recent efforts, spearheaded by the World Bank,[24] have resulted in a significant number of LICs enacting new procurement legislation and establishing procurement regulatory authorities responsible for oversight of decentralized procurement. While useful

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[20] Donors could also encourage recipient countries to participate in the General Data Dissemination System (GDDS) and finance a scheme for data improvement developed under the GDDS.

[21] This is the case in some Francophone African countries that exhibit characteristics (e.g., emergence of arrears) of a poorly functioning control system in spite of multiple controls being applied at various stages of the expenditure chain. FAD TA advice, in such cases, has been to simplify and rationalize the complex structure of control.

[22] All expenditure transactions need not pass through the same control/verification process and a case could be made for a differential treatment of high value and risk-prone transactions vs. low value transactions. However, the design of such a control system would depend on several factors, including the effectiveness of an ex post internal audit system to identify irregular transactions.

[23] Ghana is a good example of an LIC that has made encouraging progress in strengthening its personnel and payroll system. It adopted a new computerized Integrated Payroll and Personnel Database in 2006 and is finalizing the integration of this data into the budget.

[24] World Bank policy is to build sufficient capacity in countries so that loans can be channeled through their national procurement systems rather than being ring-fenced as donor operations. Diagnostic analysis of these systems, and measures recommended to bring them into line with international good practice, are provided through the Bank's CPAR.

progress has been made, much capacity building remains to be done. Strengthening procurement is essential to maintaining donor confidence to continue funding through the budget, and is one of the key measures identified in the 2005 Paris Declaration and follow-up work. Relatively simple measures that countries can take, with TA support, to strengthen procurement include developing standard bidding documents, streamlining and computerizing the system for recording bids and contract awards, publishing such information in the official gazette, and, later in the process, developing an e-procurement system.

Integrating donor aid in the budget process

20. **Scaling-up of aid will place additional burdens on already weak aid management and expenditure reporting systems.**[25] Many LICs have been addressing this matter for years, some more successfully than others. Although a significant part of the aid will hopefully come in the form of budget support, much of it may remain tied, either under sector-wide financing agreements or as individual project financing. Some of this aid will also continue to be channeled totally outside the budget, due to the preferred modalities of some of the important donors, while some will be shown on the budget but will be difficult to account for, as the aid may come in the form of goods and services (including foreign personnel).

21. **Measures to strengthen the aid management system should be agreed upon between the authorities and the donors**, with the following objectives: (i) improving the predictability of aid flows in-year and between years by encouraging donors to program their aid on a medium-term basis; (ii) incorporating reliable and timely information from donors on expected aid flows in the government's MTFF and budget plans; and (iii) eventually, disbursing and tracking aid through the government's budget execution system.

22. **A strengthened aid management system has several important characteristics.** Firstly, the unit responsible for managing aid should ideally be based in the MoF, and mechanisms should be established to ensure adequate coordination with both the budget and treasury departments, on budget formulation and expenditure tracking, respectively. Second, at appropriate points in the budget cycle, strategic policy dialogues between the government and donors should take place to ensure alignment of aid with budgetary priorities. This prioritization process should cover both direct budget support and aid delivered directly by donors. Third, the policy dialogue, donor commitments, and reporting of aid disbursements should be aligned with the national budget timetable and fiscal year to maximize allocative

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[25] Section IV of Heller and others (2006) discusses this issue in some detail.

efficiency.[26] Agreement should also be reached on simple definitions of key concepts such as expenditures, commitments, and disbursements.

Tracking poverty-reducing expenditures

23. **Special attention has to be paid to tracking poverty-reducing public spending so that it reaches the intended recipients.** Strengthening the key PFM areas identified above is critical to achieving desired expenditure allocations. Public Expenditure Tracking Surveys (PETS) and audit reports can help identify persistent weaknesses in the expenditure chain by estimating the amount of public funds that actually reaches front-line service delivery units through the budget system.[27] These techniques can be helpful in assessing the quality of cash management and internal control systems, and focus attention on the need for reform in these areas and, eventually, strengthened mechanisms of internal and external audit.[28] In particular, poor resource management can result from excessive discretion in budgetary procedures in an environment with weak internal controls, imperfect information, and vested interests. The basic elements of an expenditure tracking mechanism are shown in Box 3.

24. **All poverty-reducing spending should be monitored because of fungibility in resource use.** If resources are fungible, then a recipient country can offset the scaled-up aid that is intended for additional poverty-reducing programs by lowering its own spending in those areas.[29] This problem is compounded by the difficulty of determining a counterfactual, that is, what a government would have spent on poverty reduction in the absence of higher aid flows. In addition, earmarking aid could introduce inefficiencies in expenditure allocations as noted earlier, straining the capacity of already weak PFM systems, reducing the flexibility of governments to reallocate resources in response to changing conditions and priorities, and hampering the implementation of expenditure smoothing. Efforts to strengthen PFM systems, promote greater transparency, improve budget procedures and reporting, and prepare medium-term frameworks (MTFs) should also reassure donors that aid will be used effectively and encourage them to channel more aid through the budget.

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[26] For example, in order to prioritize resource allocation in the national budget, the MoF would need to know at a minimum both donor commitments of aid in different sectors over the next few years and disbursements to date.

[27] However, it is not possible to track all types of spending in this way, such as certain large-scale infrastructure spending.

[28] Uganda initiated a PETS to assess potential leakage of funds following a dramatic increase in primary education spending that failed to boost enrollments. The survey found that 87 percent of the nonwage resources were diverted to other uses. Several lessons emerge from similar tracking surveys in Ghana, Honduras, Madagascar, Mozambique, Papua New Guinea, Rwanda, Senegal, Tanzania, and Zambia. See World Bank (2004) and Reinikka and Smith (2005).

[29] Feyzioglu, Swaroop, and Zhu (1998) have shown that earmarked project aid to developing countries is largely fungible.

Box 3. Illustrative Expenditure Tracking Mechanism

The essential component of an effective mechanism for tracking poverty-reducing expenditures is a budget classification system that conforms with the international standard:

- At a minimum, a basic economic and administrative classification of expenditure should be put in place. This would allow administrative units to be "aggregated" into sectors that allow poverty-reducing expenditures to be tracked at a broad level;
- A functional classification of expenditures would provide a better indication of the allocation of expenditures within a sector or subsector, and hence allow improved tracking against the government's poverty-reducing priorities; and
- A simple program classification would provide additional information for more detailed policy analysis and evaluation of aid effectiveness.

In addition, for aid that is delivered directly by donors outside the budget, donors should provide timely reports to government on disbursements:

- At a minimum, such reports should include information on aggregate disbursements by sector (aligned with government definition) and geographical location;
- If possible, data should also be provided on expenditures according to their economic classification. The most basic requirement would be a distinction between recurrent and capital expenditures, which would allow the government to adequately plan for the medium term;
- Eventually, donors should report against the functional or program classification of expenditures adopted by the government.

25. **A gradual move toward a results-oriented budget would help strengthen accountability and assess the effectiveness of different programs** (see Box 4). The notion of developing program- or performance-related budgets is not unknown in many LICs, although so far these have been limited to a few sectors, in particular health and education, which have benefited from substantial donor support in recent years. However, more advanced forms of performance budgeting—including those that seek to create rules linking funding and results—require significant capacities and resources for successful implementation, and are likely to be generally unsuitable for LICs until the more basic elements of good budgeting have been developed. In general, best results have been obtained by starting with piloting the new approach in a few selected ministries before rolling it out government-wide; this helps build experience and adapts the approach to a country's environment.

Box 4. Initial Steps Toward Establishing a Results-Oriented Budget in LICs

The experience in OECD countries, as well as South Africa, shows that introducing a performance perspective in the budget process can bring substantial benefits. Mali is among the few LICs which have introduced a program budget approach, while several others are moving in this direction, notably Ethiopia. Initial steps could include:

- **The identification of programs and implementation of a program-based budget classification**. The objective of a program classification is to shed light on *what* is being achieved, in relation to the intended outcomes and outputs of government activities, as opposed to an organizational and economic classification, which is the basis for a traditional budgeting system. Steps should also be taken to improve the accounting basis and costing of programs.

- **A gradual reduction of the number of lines in the budget**. For various reasons, many countries have developed a very detailed and complex budget, consisting of thousands of individual line-items, each specifying the amount of resources that can be spent for a given purpose. In many cases, these lines can be combined into larger items, without necessarily losing control over budget execution. Such a change marks a shift in the focus of budget execution from input control to monitoring and evaluating the outcomes and outputs of expenditure programs.

- **The introduction of performance goals/targets and information on outcomes and outputs into the budget documents**. For such data to be useful for decision makers, it is critically important that they be developed and produced in close contact with policy-implementing ministries and agencies. The performance information is relevant only if it is realistic. The development of objectives and expected results for the government sector is a challenging exercise even for developed countries.

IV. Formulating and Implementing PFM Action Plans

26. **LICs should prepare an action plan for strengthening fiscal institutions and PFM systems based on the analysis of core requirements outlined above.** Successful design and implementation of such a plan depend on the following factors:

Critical success factors in preparing an action plan

27. **First, the preparation and implementation of an action plan should be based on a thorough diagnostic assessment of the strengths and weaknesses of the existing PFM systems.** In many cases, such assessments have already been carried out, and the focus of attention can switch to implementing required measures. The action plan should be discussed and agreed with all stakeholders and agreement reached on the support that may be required from external partners in the form of loans, grants, or TA.

28. **Second, donors have a responsibility to ensure that their efforts are well-structured and coordinated with a country's policy priorities and budget cycle.** Key roles and responsibilities of donors are shown in Box 5.

Box 5. Role of the Donors in Promoting Effective PFM Reform

- **Donors should encourage the national authorities to establish institutional arrangements** that facilitate effective communication between the MoF, the ministry of planning, and other agencies (e.g., the prime minister's office) involved in the process of planning and disbursing official aid.

- **Donors should play their part in producing realistic projections of donor disbursements of aid.** Although *project aid* often suffers most from unrealistic projections, IMF-supported programs in LICs are often affected by late disbursements of *general budget support* by the multilateral donors.

- **Donors should resist earmarking aid for specific purposes.** Donors often give less attention to the budget priorities of the recipient country, while in practice disbursing money at their own rhythm for projects they conceive to be useful. In other cases, national producers are rewarded by tying aid to national products and services.

- **Donors should ensure that full information is provided on actual aid disbursements, whether in cash, in-kind, or by direct reimbursement to suppliers**, and to the extent possible attempt to satisfy their national authorities' requests for such information by using the recipient countries' own reporting and accounting system.

- **Donors should ensure that, once funds are disbursed, the accounting and banking records of donors' *own* bank accounts are reconciled in a timely manner.** Ideally, donor accounts should be integrated with the government's treasury system.

- **Donors can do much to encourage transparency, participation and accountability in public budgeting** by supporting meaningful and regular reporting, timely disclosure of financial information, and external oversight of the budget process. They need to be more aware of the political economy factors that influence the behavior of partner governments, including the potential impact of their own behavior on domestic processes.

29. **Third, studies have demonstrated that political economy factors are equally as important as technical issues in the success (or failure) of PFM reforms.** This helps explain why such reforms are so difficult to achieve and are often slow to implement.[30] Recent studies of PFM reforms in Ghana, Malawi, and Mozambique demonstrate that while sound budgetary rules and procedures may be in place, they are frequently distorted by

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[30] For example, the development of a new budget classification system is a basic building block for other reforms such as a workable accounting and reporting system, a treasury single account and a rudimentary performance monitoring system. Such a system can take 2–3 years to implement, and a further 4–5 years to computerize.

informal practices which determine the actual distribution of budgetary resources.[31] The studies reveal that dysfunctions and distortions occur at all stages in the budget cycle. They underscore that demand for better governance and greater accountability is a key driver of change in budgetary systems.[32] They also suggest that incremental reforms are more likely to be successful than “big-bang” approaches, especially those that seek to incorporate models of reform imported from other countries.

30. **Fourth, champions and leaders of the reform process should be identified within the government or other public sector agencies**, and used to manage and drive the reform process. PFM reforms need to be linked to the annual budget cycle.[33] Mechanisms should be put in place to promote effective coordination of the reform program among the authorities, the donors, and other stakeholders, using formal partnership agreements where appropriate. Such mechanisms are likely to vary from country to country: some take a relatively broad view of public sector and governance reform (not confined to PFM) and include mechanisms to coordinate, and improve the predictability of, donor aid provision. Box 6 provides an example from Mozambique, which has pioneered an innovative and relatively successful approach to coordination—relying on donor resources, the ongoing availability of FAD expertise through resident advisers and the authorities’ strong commitment—to facilitate the implementation of an ambitious PFM reform program. In addition, the reform process should allow for periods of consolidation to reduce the risk of “reform fatigue.”

31. **Fifth, the main constraints to reform should be identified early on and means found to eliminate or reduce their impact.** Such constraints may be legal (e.g., the absence of a suitable legal framework), technical (e.g., the absence of a good budget classification), institutional (e.g., rivalries between different ministries, agencies, or departments over managing the budget process), or political. It is often useful to include an analysis of constraints within the terms of reference of diagnostic studies or technical assistance missions, and to discuss with the recipient government methods of dealing with them.[34]

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[31] Santiso (2007).

[32] A recent study of budget reform in South Africa highlights the importance of political commitment, a simple framework and transparent norms, comprehensive implementation, convincing stakeholders of the importance of reform, stronger leadership by a central agency, building capacity, and demonstrating quick wins. See Fölscher and Cole (2006).

[33] There are two main aspects of this: (i) budget offices are especially busy at certain points in the year and have little time to focus on new reform initiatives at such times; and (ii) certain reforms, e.g., a change in the budget classification, can only be introduced at the beginning of a fiscal year. In some countries, e.g., Tanzania, formal consideration of new reform initiatives has been institutionalized as part of the regular budget calendar, and involves consultation with TA providers and other stakeholders.

[34] This approach could build on interesting work done by Hausmann, Rodrik, and Velasco (2006) in relation to alleviating the most binding constraints to economic growth.

Box 6. Coordination of PFM Reform: the "Mozambique Model"

After many years of facing problems with TA coordination, and having made little progress in reforming crucial PFM areas, the government decided in 2002 (following an FAD mission recommendation) to take several measures to strengthen coordination of the reform process and TA delivery, including greater centralization:

(a) **The creation of an administrative unit** (UTRAFE) in the MoF (headed by a coordinator, at director level, reporting directly to the minister) in charge of implementing the PFM reforms, and the subsequent decision (expressed in a formal agreement signed by the main development partners) to eliminate parallel bilateral TA provided directly to any MoF directorate.

(b) **The creation of a Partners Committee for the PFM reforms**, chaired by the UTRAFE coordinator, and comprising representatives of the main TA donors in the country, and the IMF and World Bank resident representatives. The international donors established a common fund to finance UTRAFE's operations and the PFM reforms through bilateral commitments expressed in a formal agreement with the government (similar arrangements were made for reforms of the civil service and revenue administration).

(c) **The invitation to the Fund (a "neutral" entity) to place a PFM resident advisor in the country** directly linked to the UTRAFE coordinator. The advisor, in practice, began to coordinate all PFM TA delivered to the MoF.

(d) **The "Mozambique model" also comprises a Quality Assurance Group**, established in late 2003, comprising four PFM experts. The group undertakes missions to Mozambique twice a year to assess locally implementation progress. Its reports are distributed to the international partners and the government.

32. **Sixth, country authorities could consider using a "platform" approach in structuring a plan for sequenced reform,** in which a number of stages of reform are identified and indicators of success for each stage of reform are used to determine when to move on to the next stage.[35] Such an approach can help to strengthen linkages between the various components of the reform process (business processes, human resource management, training and capacity building, IT systems, etc.).[36] It can also help to avoid initiating certain reforms for which the preconditions for success do not yet exist. For example, the implementation of government financial management information systems has often been undermined by an exclusive focus on IT systems without sufficient consideration of the conceptual design of business processes and user requirements. Similarly, MTEFs have often been established in LICs before essential preconditions are in place thus undermining their purpose and effectiveness. An illustration of how a budget formulation system might be developed through a series of stages or platforms is shown in Table 1 below.

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[35] Country-specific PFM weaknesses would normally be identified through diagnostic assessments, such as the PEFA framework.

[36] For a discussion of the "platform" approach to reform, see Brooke (2003). The approach has been applied in a number of LICs–see, for example, Royal Government of Cambodia (2004).

Table 1. Illustrative Platforms for Strengthening Budget Formulation in a Typical LIC

Platforms	Priority-setting process	Macrofiscal forecasting capacity	Planning instruments and budget process	Capital and recurrent budgeting	Performance budgeting	Budget classification and chart of accounts	Donor aid coordination	Capacity of government to manage scaled-up aid
Initial System	Top-down approach, dominated by presidency and ministry of planning (MoP) with MoF in a supporting role	None	National Development Plan (NDP), PRSP and annual budget—largely disconnected	Dual budget system—MoP responsible for capital investment and MoF for recurrent expenditures	None	Basic system of administrative and economic classification, not compliant with GFSM 2001	Donor aid flows uncoordinated and largely managed outside the budget	Low
First Platform: Basic System (1–2 years)	As in initial system but improved coordination within government and with donors	Small unit in MoP	Simple MTFF. Improved coordination among NDP, PRSP, and annual budget	As in the initial system	Rudimentary classification introduced for pilot sectors	Economic classification compliant with GFSM 2001	Better coordination through government/donor group, but aid largely executed outside the budget	Low
Second Platform: Intermediate System (3–5 years)	Top-down but with involvement of key sector ministries and a stronger role for MoF	Small units in MoP and MoF	MTBF in place. Forward estimates incorporated in budget—NDP focuses on longer-term priorities	Integrated budget managed by MoF but some role for MoP	Rudimentary performance information for pilot sectors	Functional classification compliant with GFSM 2001. Basic program classification	Strong donor coordination; most aid flows executed by the treasury	Medium
Third Platform: Final System (6–10 years)	Mixed top-down and bottom-up. Prominent role for MoF. Some decentralized decision making to sectors	Strengthened unit in MoF	Functioning MTFF and MTEF in place	Integrated budget managed by MoF	Introduction of program budgeting linked to MTEF	Classification fully compatible with international good practice	Donor aid estimates incorporated in MTFF and budget; aid flows executed by the treasury	High

33. **Two qualifications of the platform approach should be mentioned.** First, it focuses on the vertical relationship of the various stages of reform in any one area. However, it ignores the horizontal relationship that exists among reforms in different areas. For example, the introduction of program budgeting (third platform in Table 1) is not only dependent on the successful implementation of a program classification for pilot sectors (second platform), but also on corresponding improvements in the accounting system that enable the accurate recording of expenditures and the generation of consistent and timely reports. These linkages should be taken into account when applying the platform approach in practice. Second, the platform approach can be misapplied in practice and lead to the overloading, and overly rigid structuring, of the reform agenda in countries with weak capacity. As discussed in a recent Department for International Development (DFID) report, pursuing a large number of reforms simultaneously without considering their technical feasibility and political feasibility is likely to fail.[37]

34. **Seventh, the process of implementing any individual reform (for example, developing a new budget classification) should be decomposed into a series of functional components, each of which represents a specific characteristic or requirement of the reform process.** These characteristics might comprise, for example, changes to fiscal laws and regulations; the sensitization of stakeholders, including the legislature; the development of a conceptual design for the new system; the reengineering of technical procedures and business processes; the introduction of appropriate information systems and IT systems; the preparation of technical manuals for staff; and the recruitment and training of staff. The reform program needs to develop along all the required paths; blockages or inefficiencies may arise if progress in one area becomes misaligned or out of step with progress in another.[38]

35. **In addition, the action plan should outline key medium-term reforms where change will occur more gradually**, in particular:

- **Developing capacity in the related areas of treasury systems, cash management and debt management** to strengthen budget execution and help countries build their own medium-term debt strategy.

- **Strengthening the capacity of subnational governments**: As noted earlier, delivery of services such as education, health and water is increasingly being delegated to subnational governments, which typically have PFM systems that are weaker than those of the national government. Effective use of aid for such services would require strengthening PFM at the subnational level also.

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[37] Santiso (2007).

[38] This approach to reform has been applied to the Canadian federal government—see McDonald (2002). However, the basic principles can be applied to countries at varying stages of economic and institutional development.

- **Linking PFM reforms to broader public sector reforms**: The PFM reform action plan will be stronger if it is part of a broader reform of the civil service, governance and transparency, and the legal framework.

- **Gradually increase the role and capacity of accountability institutions such as the national audit authority**, whose mandate could be expanded to include undertaking value-for-money audits of key expenditure programs and donor aid projects.

The role of TA in supporting the PFM reform process

36. **Recent IMF and World Bank evaluations have provided an insight into the key drivers of the success or failure of TA activities in the PFM area.**[39] In some cases there have been significant deficiencies and gaps in the design and implementation of TA programs. These include: (i) inadequate diagnostic assessments, which in some cases lack concrete recommendations as to how deficiencies in PFM should be addressed; (ii) contradictory advice and recommendations from different donors and TA providers; (iii) unsatisfactory selection of experts to undertake TA assignments and poor quality control of the work carried out; (iv) insufficient attention to sequencing reform measures and developing a structured action plan based on a realistic assessment of a country's political commitment to reform, its leadership and capacity to deliver; (v) in some cases, overloaded reform agendas that are beyond the capacity of the countries concerned to oversee and implement effectively and/or fail to provide sufficient clarity on the key milestones in the reform process; and (vi) underestimation of the political economy and institutional obstacles to reform, capacity constraints, and the time and sequencing required to build sustained momentum of the PFM reform agenda within the country concerned.[40] Further, there is a need to focus on monitoring the deliverables and impact of the reforms, and where necessary ensuring systematic follow-up by TA providers.

37. **Action is required on several fronts to address these concerns.** First, donors and LICs have recognized in the Paris Declaration the need to improve the design of PFM reform programs and the modalities of TA support activities, and to establish effective measurement systems for monitoring both TA delivery and improvements in PFM systems in the countries concerned. The PEFA program, in particular, emphasizes the importance of strengthening the framework for undertaking PFM diagnostic assessments; increasing government ownership

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[39] IMF (2004, and 2006) and World Bank (2005).

[40] One recent evaluation study found that some recommendations were not sufficiently detailed in regard to: strengthening the budget office (Chad), reviewing the budgetary process (Madagascar), developing analytical tools for reviewing the budget (Niger), and elaborating a macroeconomic framework for budgetary projections (Senegal and Côte d'Ivoire). See IMF (2006).

of such assessments and the related reform action plans; avoiding multiple missions with multiple objectives; and monitoring the impact of TA interventions and the resulting improvements in PFM systems. While there are some current concerns about the quality of the diagnostic assessments carried out under the PEFA framework, this initiative should be encouraged.

38. **Second, effective coordination between TA providers and the authorities is critical to the success of PFM reforms.** There are often numerous donors providing TA in LICs, underscoring the need for effective coordination. While the country authorities should ultimately be responsible for coordinating donor activities, limited capacity or scarce human resources can require that a major donor assume this role. One promising initiative in this field is the enhanced collaboration between the Fund and the World Bank to support PFM reform in a group of African countries—including Burkina Faso, Ghana, Malawi, Mozambique, Rwanda, and Tanzania—using a range of lending instruments and TA operations.[41]

39. **Third, the Fund is playing an important role in supporting countries develop and implement medium-term action plans for PFM reform, in collaboration with other development partners.** The Fund has expertise in many of the areas that are critical to support the short-term capacity-building effort in LICs—for example, budget classification, accounting, internal control and fiscal reporting. Such assistance should emphasize country ownership of the reforms; learn from lessons of the past to use TA more effectively; where appropriate, make effective use of external finance and partnership arrangements with the World Bank and other TA providers; and leverage the resources of staff from headquarters and the RTACs. Given the Fund's limited resources and specialized expertise in core areas, coordinating with other donors is essential to avoid wasteful overlap and mixed messages.

[41] Fund support for PFM reform is primarily through the PRGF program and technical assistance (e.g., placing resident PFM advisers in the MoF). Key World Bank instruments include its development policy lending and investment lending operations, as well as related economic and sector work such as public expenditure reviews.

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