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Public Financial Management

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PFM: Why does it matter and how best to improve it?

What is Public Financial Management (PFM)?

PFM refers to the set of laws, rules, systems and processes used by sovereign nations (and sub-national governments), to mobilise revenue, allocate public funds, undertake public spending, account for funds and audit results. It encompasses a broader set of functions than financial management and is commonly conceived as a cycle of six phases, beginning with policy design and ending with external audit and evaluation (Figure 1). A large number of actors engage in this 'PFM cycle' to ensure it operates effectively and transparently, while preserving accountability.

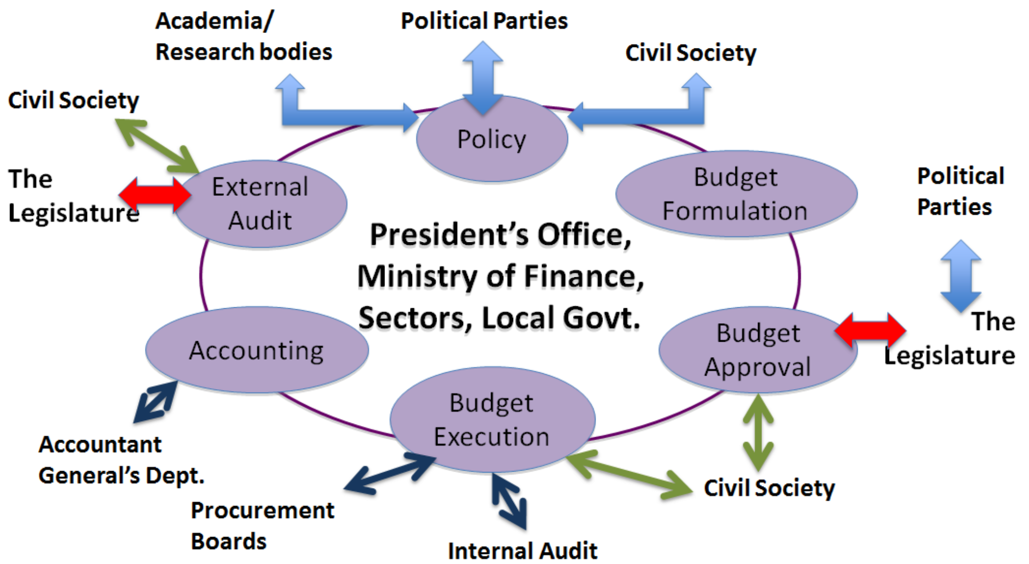

Figure 1: The PFM cycle and the key actors involved

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Why is PFM important?

A strong PFM system is an essential aspect of the institutional framework for an effective state.

- Effective delivery of public services is closely associated with poverty reduction and growth, and countries with strong, transparent, accountable PFM systems tend to deliver services more effectively and equitably and regulate markets more efficiently and fairly. In this sense, good PFM is a necessary, if not sufficient, condition for most development outcomes.
- A key element of statehood is the ability to tax fairly and efficiently and to spend responsibly. These are fundamental characteristics of 'inclusive' state institutions, which generate trust, promote innovative energies and allow societies to flourish. (See Acemoglu & Robinson, 2012, 'Why Nations Fail' and Dani Rodrik, 2003, 'In Search of Prosperity'.)

Improving the effectiveness of a PFM system can generate widespread and long-lasting benefits, and may in turn help to reinforce wider societal shifts towards inclusive institutions, and thus towards stronger states, reduced poverty, greater gender equality and balanced growth. Even where donor staff do not seek to strengthen PFM systems, they need to understand them because they will often work through them, by providing budget support or climate finance, or with them, by providing project-financed interventions, which are then staffed and maintained through the national budget. ***In short, PFM matters, and all donor staff need a basic knowledge of PFM***.

What are the objectives of the PFM system?

In order to assess a PFM system, we first need to define its objectives – the final outcomes, by which performance can be measured. It is generally accepted that a PFM system should achieve three objectives, to which we here add a fourth – the promotion of accountability and transparency. This is increasingly seen as an objective in itself, because of its close relationship to the notion of inclusive institutions.

- The maintenance of aggregate fiscal discipline is the first objective of a PFM system: it should ensure that aggregate levels of tax collection and public spending are consistent with targets for the fiscal deficit, and do not generate unsustainable levels of public borrowing
- Secondly, a PFM system should ensure that public resources are allocated to agreed strategic priorities – in other words, that allocative efficiency is achieved
- Thirdly, the PFM system should ensure that operational efficiency is achieved, in the sense of achieving maximum value for money in the delivery of services
- Finally, the PFM system should follow due process and should be seen to do so, by being transparent, with information publicly accessible, and by applying democratic checks and balances to ensure accountability.

How do we know whether a PFM system is performing adequately or not?

Ideally, one would assess the PFM system simply by measuring performance against these four objectives. To a degree, this is possible. The achievement of fiscal discipline is straightforward to measure at an international level, and the Open Budget Index (OBI) provides a reasonable proxy for transparency. However, to measure allocative and operational efficiency requires special studies. Some OECD countries and more advanced middle income countries (such as South Africa) undertake these regularly through programme evaluations or value for money audits. Some Public Expenditure Reviews (PERs) also address these issues but, in general, such studies are not common in developing countries and their structure rarely allows for easy international comparison.

In practice, the assessment of PFM systems focuses one level down from final outcomes – that is on the examination of the institutions, rules and procedures most likely to ensure the achievement of the key objectives of the PFM system. This approach was pioneered in the 1930s and revived by Allen Schick at the Maryland School of Public Policy (Reading 1). The approach provides the conceptual basis for the Public Expenditure & Financial Accountability (PEFA) assessment framework, developed by the IMF and the World Bank in conjunction with the EU, DFID and other bilateral donors. It provides a set of 31 high-level indicators by which to measure the performance of a PFM system. Since 2005, some 300 PEFA assessments have been undertaken of national and sub-national PFM systems in over 100 countries. Despite the inevitable shortcomings of a standardised system of measurement of this kind, the PEFA framework has justifiably gained wide acceptance and, when properly interpreted, provides a good guide to the status of PFM systems. An updated set of PEFA indicators is to be issued in 2015 (pefa.org).

What is known about how best to strengthen PFM systems?

Since the late 1990s, DFID and other donors have devoted an unprecedented level of attention to the reform of PFM systems in developing and transition countries. Yet, the results have been mixed. With some exceptions, reform progress has been slow and the benefits elusive. Nevertheless, some countries have been more successful in implementing PFM reforms than others. What explains this difference in performance? And what implications does it have for the design of reforms and for the provision of external support?

Recent research and evaluation suggests that three critical ingredients are needed for successful PFM reform:

- **Leadership** – a strong political and technical commitment, clear communication and coordination of reform, and a widening group of reform leaders who manage fears, expectations and differences of opinion.
- **Policy space for developing appropriate reforms** – a thorough understanding of the context, a focus on the functionality of the system and not just the form, and teams and organisations that experiment and take risks, interrogating both the problem and the proposed solutions.
- **Adaptive, iterative and inclusive processes** – where monitoring, learning and adaptation are key.

While these lessons may seem obvious in retrospect, evidence suggests that many past donor interventions to support PFM reform have ignored them – attempting to drive reform from the outside, and imposing 'blueprint solutions' inappropriate to the context. Many governments, unwilling or unable to engage in genuine reform processes, have often bought into this charade, pretending to adopt reforms but in reality adopting form rather than function. Current research on PFM issues focuses on understanding better the approaches and techniques that can help to avoid this. The selected readings seek to provide an introduction to this literature. Several of the readings are also relevant to an understanding of how to successfully support civil service reform, a closely related issue because weak public administration systems usually engender weak PFM systems.

Key Readings

Reading 1: Schick, A. (1998). *A Contemporary Approach to Public Expenditure Management*, World Bank Institute, Washington DC, Chapter 1, pp. 1-27
http://documents.worldbank.org/curated/en/1998/05/6573357/contemporary-approach-public-expenditure-management.pdf

Schick outlines the three objectives of a PFM system and explains the characteristics of the institutional arrangements most likely to ensure achievement of these objectives. It is simply written and provides an excellent introduction to the institutional approach to PFM, which is implicit in so much of the subsequent literature. Readers are especially encouraged to analyse Tables 1.2, 1.3 and 1.4, which summarise the institutional arrangements for enforcing aggregate discipline, for improving allocative efficiency and for improving operational efficiency.

Reading 2: Ramkumar, V. and Shapiro, I. (2010). *A Guide to Transparency in Budget Reports*, International Budget Partnership (IBP), Washington DC.
http://internationalbudget.org/wp-content/uploads/Guide-to-Transparency-in-Government-Budget-Reports-Why-are-Budget-Reports-Important-and-What-Should-They-Include-English.pdf

This guide (produced by IBP, the sponsors of the Open Budget Index) is designed for civil society groups but could equally be used by donor staff to support CSO activities or to press directly for the achievement of internationally recognised standards of budget transparency. It also provides an excellent guide to the key products of the budget cycle. The Summary Table in the Annex (pp.44-47) outlines the role of key budget documents, and details their 'ideal' content and timeframe for publication.

Reading 3: Krause, P. (2013). *PFM reforms, signals and adaptation*, Conference Paper presented at the 9th CABRI Annual Conference for Senior Budget Officials, Nairobi, August, 2013.
http://www.cabri-sbo.org/resources/publications/reports/760-exploring-the-missing-links-in-public-financial-management-reforms-9th-annual-seminar.pdf (pp.7-8)

Philipp Krause (ODI) provides a critique of the practice of transposing 'international best practice', without regard to the domestic context. He describes the widespread adoption of such models as a process of imitation rather than innovation, and, at its worst, a mere process of ventriloquism. This is when only the form rather than the function has been imitated, the purpose being to provide a reform 'signal', while actually serving to hide the absence of real reform. The article stresses the importance of doing away with the donor-driven incentives that generate such behaviour.

Reading 4: Lawson, A. (2013). *Successful PFM reforms: what is the right context and what are the right mechanisms?* Conference Paper presented at the 9th CABRI Annual Conference for Senior Budget Officials, Nairobi, August, 2013.
http://www.cabri-sbo.org/resources/publications/reports/760-exploring-the-missing-links-in-public-financial-management-reforms-9th-annual-seminar.pdf (pp.8-9)

This conference paper presents a summary of a more substantial evaluation of ten years of PFM reforms in Burkina Faso, Ghana and Malawi between 2000-2010. Based on an analysis of nine case histories of PFM reform within these countries, it emphasises the importance of political leadership, strong coordinating mechanisms, policy space, innovation and learning. The case histories help to bring alive these cross-cutting lessons, providing useful details on the specifics of reform design and management.

Reading 5: Andrews, M., Pritchett, L. and Woolcock, M. (2012). *Escaping Capability Traps through Problem-Driven Iterative Adaptation,* Centre for Global Development (CGD) Working Paper 299, Washington DC. http://www.cgdev.org/publication/escaping-capability-traps-through-problem-driven-iterative-adaptation-pdia-working-paper

Matt Andrews and his colleagues show how the practice of 'mimicry' (also described in Krause) serves to perpetuate 'capability traps', in which state capability stagnates or even deteriorates, even though governments remain engaged in development rhetoric and continue to receive development resources. They recommend a different approach to supporting PFM and other reforms, described as Problem-Driven Iterative Adaptation (PDIA), which emphasises solving locally defined problems through experimental approaches that promote learning and adaptation.

Reading 6: Petersen, S.B. (2006). *Automating Public Financial Management in Developing Countries*, John F. Kennedy School of Government Faculty Research Working Paper Series RWP 06-043, Harvard University. http://www.hks.harvard.edu/m-rcbg/papers/peterson_oct_2006.pdf

Many PFM reforms involve the introduction of Integrated Financial Management Information Systems (IFMIS), often at substantial cost in financial outlays and administrative efforts. Experience shows that these systems often fail or under-perform. This paper provides a framework and a case study from Ethiopia, illustrating an approach that has worked, and which effectively endorses the PDIA approach to reform – although it was written before the PDIA terminology was invented.

Reading 7: Simson, R., Sharma, N. and Aziz, I. (2011). *A guide to public financial management literature for practitioners in developing countries*, Overseas Development Institute, London. http://www.odi.org/publications/6242-public-financial-management-pfm-guide

This literature review contains an exhaustive listing and introduction to key texts, covering the full PFM cycle and addressing technical issues, such as reform sequencing and design. It provides an excellent resource whenever guidance might be needed by donor staff and their counterparts on how to address specific issues of PFM, such as procurement, cash management, medium-term expenditure frameworks, programme budgets, etc.

Questions to guide readings

1. PFM is frequently seen as a 'technical' issue, when it is much more fundamentally a political and institutional issue. What gives rise to this misconception? And what can be done to promote a better understanding of the institutional essence of PFM?
   (Readings 1 and 2)
2. Andrews, Pritchett and Woolcock present 'isomorphic mimicry' – the copying of reform models from other countries – as a universally bad thing. Is this necessarily so? Do you believe, as does Krause, that mimicry might be used positively? If so, how?
   (Readings 3, 5 and 6)
3. It is a commonplace statement that leadership is needed for PFM reform to succeed. The question is what type of leadership? Does there always need to be political leadership of reforms – as the experience of Burkina Faso, Ghana and Malawi suggest? Or can leadership take more varied forms,

as some writers suggest?
(Readings 4 and 5)

4. PFM reforms should address the problems perceived on the ground by the actual users of the system. Ideally, political leaders would feel an urgency to resolve these problems; yet, what can or should be done if political leaders do not see a weak PFM system as a problem? Is there a way forward?
   (*Readings 4, 5, and 6)*

5. PFM reforms should represent locally developed solutions to locally perceived problems, so they should be based on a diagnostic process. Yet sometimes the solutions will not be clear and some experimentation may be called for; hence there is also a need for learning and adaptation. How can reformers avoid lengthy and expensive diagnostic processes, while also preventing too many failed experiments? What is the right balance between diagnosis and adaptation? Which criteria might be appropriate in defining this balance?
   (Readings 4, 5 and potentially 7)