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Public financial management reform in fragile states

Grounds for cautious optimism?

Public financial management (PFM) reform is a priority for fragile states. If a state can't tax reasonably or spend responsibly a key element of statehood is missing. The guidelines on state-building in situations of fragility and conflict established by the Development Assistance Committee of the OECD (OECD-DAC) emphasise PFM (OECD, 2011). Yet, the evidence on what works and what doesn't is limited. Andrews' study of PFM reform in Africa points out that six fragile states in a sample of 31 countries perform far worse on PFM, including budget execution, with Sierra Leone the only exception (Andrews, 2010).

This Briefing Paper outlines the findings of a recent study by the World Bank and ODI (World Bank, 2012), which sheds new light on PFM reforms in fragile states. It suggests that even though fragile states may perform less well than non-fragile states overall, substantial progress is still possible. More surprising is the evidence that, of the different dimensions of PFM, the most progress has been made on budget execution. However, there are critical gaps in our knowledge of the relationship between PFM, statehood and development progress.

Money changer at a bazaar in Afghanistan

Key points

- Fragile states with very low income and capacity can make substantial progress with public financial management reform
- New research suggests that efforts to strengthen budget execution outperform work on other dimensions of public financial management
- But we still need to know more about public financial management reforms can contribute to better service delivery and state-building

Country comparisons of PFM reform

New evidence reveals substantial progress on PFM in certain fragile states – even in countries with low public-sector capacity, legacies of protracted conflict, and low income levels. This finding emerges from a qualitative assessment of eight countries (World Bank, 2012): Afghanistan, Cambodia, the Democratic Republic of the Congo (DRC), Kosovo, Liberia, Sierra Leone, Tajikistan and West Bank and Gaza. In each, it was at least eight years since the start of PFM reforms – usually as part of post-conflict reform efforts. Substantial progress was defined as improvement across all dimensions of public expenditure management (budget preparation, budget execution, accountability and oversight), leading to well-established systems in at least some areas.

Four of the eight countries showed substantial progress, two some progress, and two only limited progress. This finding suggests that state fragility, war and protracted conflict do not automatically prevent the relatively rapid improvement of PFM systems once reconstruction begins. Progress spanned regions, colonial heritage, income level and territorial size. Where progress was substantial, there was always evidence of quite advanced reforms, such as automated financial management information systems.

This evidence should, however, be treated with caution. Four cases out of eight do not permit generalisation across all fragile states, and statements based on percentage rates of success alone are not meaningful. It would be better to ask whether the countries in this sample have characteristics in common with other countries that might provide lessons for application elsewhere.

Two of our sample countries are middle income: Kosovo and West Bank and Gaza. They are also the two cases where a central

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government has been established for the first time in an aspiring state or one that has recently gained sovereignty. They are both relatively small with well-educated populations, and their original conflicts had strong international dimensions – as opposed to conflicts caused by internal fractures. In both cases there has been a clear need to show the international community that the government is capable, which has required them to demonstrate basic PFM functionality. Both would be expected to do quite well were it not for their fragility, and each has seen substantial progress over the past decade in the face of a turbulent political environment. However, their progress may not reflect the fragile states of the future.

Afghanistan is more complex. Its protracted and on-going warfare, the lack of a legitimate monopoly on the use of violence by any actor, widespread poverty and the country's complicated geography should all work against successful PFM reforms. The same characteristics, and presumption, would hold for DRC. In Afghanistan, however, PFM reforms have been quite successful. The 2008 Public Expenditure and Financial Accountability (PEFA) assessment showed scores better than the average for middle-income countries in most PFM categories. However, the poor security situation and the exceptionally high international technical support to the central Government raise questions about the sustainability of this progress.

The record is mixed in the remaining countries. PFM reforms were attempted, sometimes comprehensively and repeatedly, in Cambodia, DRC, Liberia, Sierra Leone and Tajikistan. Yet only Sierra Leone has achieved substantial progress. No strong narrative emerges: in some cases the political economy situation was unfavourable; in others PFM was a political priority at times but interest in reform was not sustained. Donor engagement, financial support, technical assistance and capacity substitution were not enough to generate sustained progress.

Budget execution versus other PFM dimensions

Two clear patterns emerge from the eight countries on the relative emphasis and achievement in PFM reform through the budget cycle. First, budget execution exhibited the most rapid and advanced improvement across all PFM dimensions, characterised by revised charts of accounts, centralised cash management (through establishment of a Treasury Single Account) and automation of central treasury functions. Second, these gains were not matched by progress on advanced upstream reforms such as multiyear budgeting and programme budgeting – despite considerable external technical support.

Budget formulation

Substantial progress in budget formulation was confined to the basic annual budgeting process, to improving capacity for macro-fiscal analysis and forecasting, and to revising budget classifications against common standards, such as the Government Finance Statistics of the International Monetary Fund (IMF). The emphasis on restoring order and formality reflected demand by donor agencies for the implementation of spending priorities such as public sector salaries – typically in support of peace-building efforts. The cases of Afghanistan, Kosovo and Liberia, in particular, confirm budget process improvements. However, they also expose the tension between a formal improvement and the persistence of weak budget credibility through the execution process in all cases except Kosovo.

The other highlight, strengthening the macro-fiscal analysis function, is explained partly by the emergence of specialised technical units in the finance ministries in Kosovo, Sierra Leone and elsewhere, and by the close involvement of IMF staff in this element of budget formulation.

There was less progress across all eight countries on more ambitious and complex aspects of budget preparation. Attempts at multiyear expenditure planning (linked to government policy priorities) and programme-based budgeting (linked to service-delivery results) yielded limited results. Cross-country analysis of PEFA scores for multiyear fiscal and budgetary perspectives shows scores of mostly C and D. Case study research for the same countries identified the persistence of dual budgeting and negligible progress on attempts to integrate recurrent and capital budgets (World Bank, 2012).

The evidence on Medium-Term Expenditure Frameworks (MTEFs) and Programme-Based Budgeting (PBB) is important as these are often promoted by donor agencies and international PFM consultants (World Bank, 1998). Despite attempts to introduce MTEFs in seven of the eight countries, only Kosovo sustained the preparation of a full MTEF. Even Afghanistan – a showcase for PFM reform progress in fragile states – struggled to develop credible multi-year rolling expenditure forecasts or ceilings.

PBBs appear even more problematic. Despite efforts to put the budget on a programmatic footing in Afghanistan, Cambodia, Liberia and Sierra Leone, with external technical assistance, there was little evidence that the reforms gained traction or produced their intended benefits. Indeed, the experience suggests that PBB in fragile states may be counter-productive, compromising budget execution.

Budget execution

Budget execution processes and systems exhibited the most rapid and advanced performance improvement, but progress was not comprehensive. The restoration of basic fiscal control was a common downstream priority, alongside re-establishing a formal budget preparation process and producing an annual (or part-year) budget. Typical reforms were revised charts of accounts, centralised cash management through establishment of a Treasury Single Account (TSA), automation of central treasury functions, and strengthened fiscal reporting (World Bank, 2012). Some measures are quite advanced according to standard sequencing models.

The successful implementation of TSAs requires the centralisation of financial control to the finance ministry and reduces the discretion of sector ministries and government agencies to run their own accounts. It is assumed that such measures are challenging in fragile states because of limited central budgetary authority in the absence of strong financial management capacity and a cohesive political settlement. However, Afghanistan, Cambodia, Kosovo, Sierra Leone and West Bank and Gaza all established TSAs. Even DRC managed to close line ministry bank accounts.

Linked to progress on TSAs was a drive to introduce computerised Financial Management Information Systems (FMIS), primarily for central government treasury functions (e.g. payments and reporting) but rolled out substantially to varying degrees in Afghanistan, Sierra Leone and West Bank and Gaza. Budget recording and reporting showed progress in the most difficult contexts and even where the least reform progress was seen overall, such as DRC and Tajikistan. Progress in the automation of systems was often driven by a desire for centralised financial management and achieved by boosting technical capacity through donor-funded local and international technical advisers who extended the potential frontiers of reform.

However, even where compliance to stronger execution systems was relatively good, the credibility of the originally approved budget was weakened through procurement practices, in-year budget adjustments and supplementary appropriations. Relative weaknesses in core areas of execution such as procurement and internal control, plus poor results on budget credibility, raise questions about the overall picture on PFM performance in fragile states.

The achievements in budget execution still remain striking, given such challenging contexts of politics and capacity. But important research questions remain, especially on sustainability: reforms in several countries were driven by high-profile finance ministers, whose terms in office can be short. It is also unclear how countries should manage the transition from heavy donor engagement in capacity building and from a reliance on substitute external capacity.

Assessing the impact of PFM reforms

What does this research tell us about the interaction between PFM reforms and improvements in state capacity, accountability and the delivery of public services? Standard frameworks show links between strengthened PFM, fiscal discipline, strategic resource allocation and the operational efficiency of public spending. Better PFM performance should also contribute to state-building goals, public accountability and service delivery.

Theory and evidence tell us little about these latter interactions, but the latest evidence sheds light on two main issues for fragile states. First, high levels of state capacity are associated with higher levels of PFM reform progress. Second, attention to formal accountability mechanisms and de-concentrated levels of authority often comes late in PFM reforms. This explains, in part, weaker performance in those areas.

Improvements in state capacity

It is assumed that a functioning PFM system is a core element of statehood. States that are unable to tax and spend competently, accountably and responsibly are, by definition, weak. However, there is little evidence – or theory – to suggest how the different elements of statehood interact during state-building in fragile contexts. Familiar historical precedents don't help, because Western European budgets and treasury systems evolved alongside external accountability and administrative capacity, making it impossible to establish which caused which. We do not know enough about state-building to understand how the different dimensions of statehood fit together. Specifically, does progress on externally-supported PFM reform lead to state-building in other areas, and over what timeframe?

A comparison of progress on PFM reform with measures of general state capacity (Table 1) reveals concurrence. Successful PFM reformers also do relatively well on other aspects of state capacity, and improve over time, without clear indications of causality. One key example of PFM having a positive impact is found in West Bank and Gaza, where the Government pursued PFM reforms as a means to gain credibility as an aspiring state. The reforms were cast explicitly in that narrative and gained international approval. The clearest outlier in the other direction is Afghanistan, where strong PFM performance contrasts with an otherwise bleak picture on overall state capacity – an inconsistency that casts doubt on the sustainability of its PFM progress.

Table 1: Overview of PFM reform progress

Country	Relative progress on PFM rebuilding and reforms by 2010	Overall state/admin capacity
Afghanistan	Substantial progress	Weak
Cambodia	Some progress	Weak to intermediate
Democratic Republic of the Congo	Limited progress	Extremely weak
Kosovo	Substantial progress	Intermediate
Liberia	Some progress	Weak to intermediate
Sierra Leone	Substantial progress	Weak to intermediate
Tajikistan	Limited progress	Weak
West Bank and Gaza	Substantial progress	Intermediate

Source: Authors' summary of Bertelsmann Transformation Index score of Government Management Performance and World Governance Indicators Score of Government Effectiveness (p.54)

Progress in financial accountability

Accountability mechanisms in a country go beyond the functioning of a PFM system. However, improving the formal mechanisms of public financial accountability is a step towards tackling acceptance of the abuse of public resources. Despite the importance of this issue, mechanisms such as external audit and legislative scrutiny have received limited attention in PFM reform programmes in fragile states (World Bank, 2012). It is no surprise, therefore, that these PFM dimensions also register less progress and tend to be associated with the lowest average scores across the budget cycle, according to the PEFA framework.

Parliamentary scrutiny remained the weakest PFM function across the eight cases studied – a result, in part, of limited reform effort and weak political incentives. There have been selective attempts to improve the external audit function. In Kosovo, for example, the external audit was outsourced and an international was appointed as Auditor General, while in Liberia the Auditor General was appointed on a direct donor contract. There were improvements in public audit in both cases, but parliamentary oversight and follow-up remained weak, preventing real gains in budget accountability.

Improvements in service delivery

Strengthened PFM systems should support more efficient and effective delivery of public services by facilitating the flow of funds from the centre to front-line units. This requires improvements in PFM functionality that span the service chain, reaching beyond the central finance agency and line ministries to regional governments, local administrations and service units (such as schools and clinics).

In the eight countries examined, PFM reform programmes have focused primarily on central finance ministries, overlooking reform efforts at the level of sector ministries and sub-national governments. Selective efforts were made for priority sectors, such as education and health in DRC, Kosovo, Liberia and Tajikistan, but these were marginal when compared to the main focus on the finance ministries. This emphasis was driven largely by the prioritisation of fiscal discipline and financial control to counter fragmentation and informality in public expenditure management practices.

Control was established in two ways: through comprehensive reforms to strengthen the capacity of central finance ministries, and by reducing the discretion of other budgetary actors (through TSAs and FMIS). Where there were PFM reform efforts at the sector and decentralised level, as in Afghanistan, DRC and Liberia, they often came during the later stages of the reform process. Short-term fiscal control imperatives tended to dominate longer-term goals of service delivery and poverty reduction.

The exceptions were Kosovo and Sierra Leone, where PFM strengthening at the sub-national and sector levels was an early government priority, given its importance for political settlements. In other cases, notably DRC, the lack of clear political direction over the decentralisation agenda hampered progress on PFM reform.

Policy lessons for fragile states

While we should avoid generalised recommendations, three main conclusions emerge from the research that could act as policy pointers for fragile states.

- Where domestic reformers see opportunities to strengthen budget execution, they should pursue them actively: evidence from other countries suggests that such reforms are more likely to gain traction. Budget reporting, centralisation of cash management and automation of treasury systems are potential entry-points.
- Advanced budget preparation reforms, such as MTEFs and PBBs, could risk becoming costly and counter-productive failures that divert scarce resources without delivering benefits – even where donors and governments show initial interest. Governments should only pursue these once a sound basic PFM system is in place, or if the case for such reforms is exceptionally strong.
- It is difficult to establish well-documented links between successful PFM strengthening and wider developmental or state-building impacts. However, some PFM reforms may succeed without being intended as tools for better service delivery. Despite the presumed importance of these linkages, we need a better understanding of how to ensure that PFM reforms have a stronger impact on development outcomes.

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