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GUIDELINES FOR PUBLIC FINANCIAL MANAGEMENT REFORM

Commonwealth Secretariat

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FOREWORD

Implementing the Millennium Development Goals (MDGs) demands effective public financial management that is imbued with transparency and accountability measures to achieve strategic outcomes. Experience shows, however, that financial resources are scarce and access is uneven. More challenging is the difficult task of mobilising the political will required to create a governance friendly environment, involving all stakeholders at the planning, execution and evaluation stages of development programmes.

Undoubtedly, developing countries, although to varying degrees, continue to grapple with the mechanics of good governance, resource management, including effective revenue generation and efficient allocation of public funds. The good news is that these lapses have been identified and robustly responded to by the Commonwealth Heads of Governments in the Abuja 2003 Declaration, where leaders committed themselves to institute transparent and accountable public expenditure management systems in member countries. The *Guidelines for Public Financial Management Reform* showcases the Commonwealth Secretariat's strategic approach in bringing to reality the desires of the Heads of Governments to usher in reforms and change the way governments do business.

The Guidelines complement similar works on public financial management reform. Users will discover it has been deliberately modelled along international best practice without iron clad prescriptions so that its content can be modified to suit local dynamics. It is a reference tool for change managers in public financial management, and it is our hope that developing countries will find it useful in their individual reform and development endeavours.

Appreciation is extended to Genesis Analytics of South Africa for conducting a case study on the South Africa public financial reform experience and for providing the initial draft that formed the basis of these Guidelines. We recognise the inputs of Gill Marcus, former Deputy Minister of Finance in South Africa and Deputy Governor of the South African Reserve Bank, Hennie Bester, Director of Genesis, Richard Ketley and Ryan Short all of Genesis.

I commend this publication to developing member countries, and use this opportunity to reassure them of the Commonwealth Secretariat's willingness to assist with practical measures to implement the Guidelines through our Public Expenditure Management Programme based in the Governance and Institutional Development Division (GIDD).

In concluding, I recognise my colleagues Professor Victor Ayeni, Director of GIDD and Dr Indrajit Coomaraswamy, Director of EAD, and their specialist staff in particular, Kaifala Marah (Adviser, Public Expenditure Management) for facilitating the work of these Guidelines.

Don McKinnon, *Commonwealth Secretary-General*

ABBREVIATIONS

ANAO	Australia National Audit Office
ANC	African National Congress
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Review
EAD	Economic Affairs Division
EU	European Union
DFID	Department for International Development
GDP	Gross Domestic Products
GIDD	Governance and Institutional Development Division
HIPC	Highly Indebted Poor Country
IFI	International Financial Institutions
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
MDGs	Millennium Development Goals
OECD	Organisation for Economic Co-operation and Development
PEFA	Public Expenditure & Financial Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PRS	Poverty Reduction Strategy
ROSC	Reports on the Observance of Standard & Codes

EXECUTIVE SUMMARY

1. Public financial management concerns the effective management of the collection and expenditure of funds by governments. As societal needs will inevitably be greater than the resources available to government, all public resources must be used as efficiently as possible with a minimum of government wastage. Efficient public financial management is central to creating a relationship of mutual trust and shared consensus between government and citizens that is at the core of the development process.

2. Reform of ineffective public financial management systems, processes and institutions in developing countries is critical to secure long-term economic success, to maximise the efficient use of limited public resources, to create the highest level of transparency and accountability in government finances and, most importantly, to generate more and better services for the citizens of the country.

3. Successful reform needs to take account of local conditions and should focus on both the *process* of reform (i.e. how to achieve the correct "enabling environment") as well as on *substantive* changes to the fiscal framework (i.e. what to change).

4. There are a number of principles that should be applied during the **process of reform**:

i. Reform must be implemented as **part of an overall strategy** which should be home-grown and country-led. Donors may contribute funds, ideas and technical skills and can develop strategies to support reform, but the reform strategy itself must be country-owned. An interactive engagement of government with business, civil society, labour and opposition parties will lend the strategy credence.

ii. Reform must start with sound policy formation at a **macroeconomic level**, including defining the purview of the state, the framework of government, key institutional arrangements, and macro-economic policy.

iii. Reform must be backed up with **political commitment** at the highest level and must enjoy continuing and unwavering support for the long-term. Financial reform is first and foremost a political process implying political costs and benefits. As such it requires astute political management backed by a real will to change. The Ministry of Finance or equivalent department should be imbued with the strongest possible political authority to oversee public financial management.

iv. **Key institutions** need to be empowered to operate autonomously from government. These include the central bank, the revenue service, and a range of oversight bodies. These institutions should be provided with full legal (or constitutional) underwriting to do their job without interference, clear and transparent mandates, sufficient financial resources and human capital talent to operate efficiently, and the political space to carry out their work.

v. Reform needs to be **managed**. Government needs to make use of all available skills. This includes harnessing global best practice and making use of all available human capital, wherever it may be found, including the existing civil service, the private sector, academic and professional bodies, donor-provided training and technical skills transfer programmes. Reform and the motivation behind reform must be communicated proactively and deliberately at every stage to citizens, donors, government employees and to the domestic and international markets. Reform is made more feasible with timely and accurate data and government must invest in statistical and analytical bodies. Reform can be more effectively managed by building healthy, respectful relationships with donors.

vi. The progress of reform must be effectively **measured and monitored** by setting performance related benchmarks and indicators vis-à-vis agreed objectives, empirical measurement of these benchmarks, and analysis thereof by oversight bodies.

5. There are a number of key changes that should be made to the **fiscal framework.**

i. Improving the **collection of revenue** is critical. No country can be run properly without revenue. Moreover, tax can help to establish a government's authority. Tax policy itself is increasingly limited by external forces: in a globalised world, governments' choices are less about the tax rate than about the efficiency with which tax is collected and the reach of the tax net. Thus, the revenue services must be properly resourced and motivated to collected tax more efficiently.

ii. **Debt and cash** must be managed efficiently. In particular, sound principles for deficit funding should be established, efficiencies sought and proper risk management procedures introduced. Proper management of the government's borrowing program will reduce the cost of funding.

iii. **Effective planning** and allocation of resources is key and government should develop and institutionalise planning processes at all levels of government. The **budgeting** process must be transparent and inclusive. There should be a focus on output rather than input-focused implementation, with strong accounting and reporting procedures. The office of the accountant-general must be properly resourced and funded to fulfil its function.

iv. Effective **oversight** and monitoring are crucial to sound governance and PFM reform. A well functioning PFM system must have clear rules on transparency and reporting, as well as enforceable sanctions for failure. Oversight should be established by internal mechanisms in the national treasury, as well as external oversight by bodies like independent parliamentary committees, a public ombudsman, a free media and civil society, and an independent auditor-general.

1. INTRODUCTION

The development of the *Guidelines for Public Financial Management Reform* can be traced to the report of the Secretary-General prepared by a team of high level experts on how democracy and development can be promoted in Commonwealth countries. The report emphasised "at the heart of democratic pro-poor development lies the process of government revenue and expenditure… that a sound and accountable system for drawing up budgets, implementing them and monitoring their impact is a key instrument for promoting pro-poor development and democracy and for building stable, cohesive societies".[1] The Commonwealth Heads of Government Declaration in Abuja 2003, consequently provided direction by committing themselves to institutionalise transparent and accountable public financial management systems in member countries.

The Governance and Institutional Development Division (GIDD), which is driving the mandate, adopted a two-tier strategy to carry out the assignment. First, in collaboration with the Economic Affairs Division (EAD), GIDD contracted Genesis Analytics of South Africa, to conduct a study on the South African public financial management reform system[2] and to draw up a discussion paper that will form the basis for broader consultation and discussion for the development of public financial management guidelines. Following submission of the paper, a brainstorming workshop was held at Marlborough House on 20 and 21 June 2005 that attracted broader consultations and discussions. Participants to the workshop were drawn from senior finance officers and consultants from ten Commonwealth countries plus representatives from the United Kingdom Department for International Development (DFID), the World Bank, the Organization for Economic Co-operation and Development (OECD), Genesis Analytics and the Commonwealth Secretariat.

The outcome of that workshop presents a comprehensive set of guidelines to assist developing countries to improve public financial management. The Guidelines are contained in this publication which recognises that no single solution can be universally applied. However, it sets out universally accepted principles, best practices and processes that can be adopted in the process of reform. In preparing the Guidelines, care was taken to create a document that can be easily used by researchers and development practitioners in developing countries.

The Guidelines is presented in two categories: the first section *Process Framework* sets out activities required to achieve an "enabling environment" for successful Public Financial Management (PFM) reform. These include political commitment to drive reforms, the development of a strategic reform framework, adopting sound macroeconomic policy and the empowerment of key institutions to facilitate reform. And second, a *Fiscal Framework* provides practical guides and key principles for effective PFM. These include robust revenue collection, interactive involvement of all stakeholders such as civil society in the budgetary process, and the consolidation of internal control measures and external oversight mechanisms in the process. The work draws on the South Africa PFM reform experience and best practices (provided in boxes where relevant) from other Commonwealth countries including Australia, Canada, India, Malaysia and Malta. However, in the event of drawing from other experiences care must be taken as national dynamics, political cultures and

[1] Making democracy work for pro-poor development, Report by a Commonwealth Group of Experts, 2003 p xvi
[2] Reforming Public Finance The South African Experience, Commonwealth Secretariat, 2006

development priorities defer. As such developing countries must be wary of plunging into reforms without assessing suitability of models and of modifying a good practice to suit the national environment.

Box1 **Caution**

The Guidelines do not amount to a template, but should rather be seen as lessons that can be adapted to other situations. One of the most striking aspects of the South African story is that the context was unique and the solutions were homegrown to suit that context. Every country has its own political, economic and social context and this should be taken into account in any attempt to reform PFM. Policy should be attuned to the political moment and context. One-size-fits-all solutions rarely work. The approach we recommend is that of learning from everyone but copying no one. Readers should be open to ideas and should be encouraged to borrow the best solutions from any number of sources. South Africa took a pragmatic approach, drawing inspiration from the concurrent federalism in Germany, from the Financial Commission in India, from debt management techniques in Sweden, from a two-phase constitution in Namibia and from the best of the PFM systems in a number of other locations, including the United Kingdom, Switzerland, Australia, Canada and New Zealand. South Africa learned from many, but did not try to copy or reproduce any single system.

Source: *Reforming Public Finance the South African Experience, Commonwealth Secretariat, 2006*

2. PROCESS FRAMEWORK ("HOW")

Reform of PFM changes the manner in which a country is governed. Money is the lifeblood of government and changing its flows cannot be done without changing the structures, processes and culture of government itself.

2.1. DEVELOP A STRATEGIC REFORM FRAMEWORK

Guiding principles

1) ***Reform needs to be implemented as part of an overall strategy.*** This does not mean that reform should not be started without a grand, well-elaborated strategy, but rather that reforms should be part of an overall strategic movement towards change (holistic public sector reform initiative) in order to enhance operations and outcomes in the public sector.
2) ***This strategy should be home-grown and country-led and should include a plan of action for reform:*** Donors may contribute funds, ideas and technical skills and can develop strategies to support reform, but the reform strategy itself must be country-owned. The practice of implementing locally conceived strategies to which donors may contribute is widely becoming acceptable to donors both bilateral and multilateral. PFM movers must therefore take advantage of the strategy because locally conceived ideas largely reflect local realities and are easy to implement with minimal hiccups.
3) The strategy should:
   a) Take an holistic view of the entire PFM process, institutions and systems;
   b) Take realistic account of the political economy and societal context, and how this may present opportunities for or blockages to delivering on the strategy;
   c) Be based on reasonable fiscal and monetary assumptions;
   d) Sequence reform from both a legal and fiscal viewpoint;
   e) Identify realistic priorities based on the sequence, given "resource envelope" and government's execution capacity;
   f) Involve wide consultation with all stakeholders - key constituencies could include public sector unions, opposition parties, state-owned enterprises, civil society, the business community, international markets and donors;
   g) Make every effort to cut government costs, reduce wastage and obtain excellent value for money;
   h) Be translated into feasible and manageable, practical programmes set up in the sequence of recognised priorities, articulated in a clear work-plan timetable with assigned responsibility.

Box 2 **Malta**

PFM reform must be part of an overall process

When in 1989 Malta sets out to introduce change in its overall management structure and service delivery system, a Public Service Reform Commission was appointed to "examine the organisation of the public service, and to recommend means by which the service can efficiently respond to the changing needs for effective government". The Commission's Report was adopted and the country embarked on comprehensive and sustained reform programmes that led to public financial management reform with a new organic budget law, and the establishment of three change agencies to drive the reform process- The Management Systems Unit (later sub divided into the Management Efficiency Unit and Malta Information Technology and Training Services), the Management and Personnel Office and the Staff Development Organisation.

In 1999, almost a decade after embarking on this grand scale reform, Malta launched the Quality Service Charter Initiative to improve its public service delivery mechanism, putting at the forefront a people oriented governance system- meeting the people's needs in time and on time. Other initiatives included e-government, efficiency reviews and public private partnerships, all of which are captured under the Public Service Change Programme.

Source: *A Profile of the Public Service of Malta, Current Good Practices and New Developments in Public Service Management. Commonwealth Secretariat, 2002. P ix-xvi*

2.2 ADDRESS STRUCTURAL ISSUES

Guiding principles

1) ***PFM reform starts with sound policy formation at a macroeconomic level.*** It should consider the following issues:
   a) ***The purview of the state*:** Countries are increasingly integrated within the global marketplace and the dynamics of the international goods, services, capital, and labour markets. More than ever before, these dynamics define the outer limits of the domestic policy environment. With maximum tax rates, debt burdens and, increasingly, wages determined internationally rather than locally, the difference between success and failure in effective PFM depends on considered and informed decisions on where the state should intervene in the economy and with which instruments. This needs to also take account of the capacity of the state to make such interventions.
   b) ***Framework of government:*** There needs to be clarity in the allocation of government functions to the respective spheres of government, and clear principles for the allocation of revenue and revenue mobilisation authority at each level. Even though there may be many relatively autonomous spheres of governments in a single country, their fiscal arrangements cannot be seen in

isolation. Both the individual taxpayer and the international market evaluate the impact of the entire public finance arena, not just one sphere of government or its activities.

c) ***Institutional arrangements:*** The level of independence, accountability and mutual relationships between key institutions, for example, the central bank, regulatory bodies, parliament, levels of government, and independent oversight bodies are crucial to creating the necessary checks and balances in the use of public resources. These roles need to be enshrined in the legal (or constitutional) framework.

d) ***Macroeconomic policy:*** A clear macroeconomic framework that determines the overall fiscal envelope over a multi-year period provides operational certainty to government departments and enables both the public and private sector to adopt a longer-term horizon.

2.3 MAKE A COMMITMENT TO CHANGE (POLITICAL WILL)

Guiding principles

1) ***PFM reform is first and foremost a political process implying political costs and benefits.*** As such it requires astute political management backed by a real will to change.
2) ***The decision to embark on a PFM reform process needs to be taken at the highest political level*** and must enjoy continuing and unwavering support for the long-term.
3) Political commitment is required to:
   a) Implement credible macro-economic policies;
   b) To cut government costs and wastages;
   c) Ensure an appropriate legal and enforcement environment for government policy;
   d) Empower key institutions with appropriate operational, legal, and independent authority (e.g. Auditor General, parliamentary committees, etc.);
   e) Give opposition parties a role in the oversight of PFM; and
   f) Ensure transparency and openness in PFM and in governance generally.
4) ***The Ministry of Finance should be imbued with the strongest possible political authority to oversee public financial management***. This mandate needs to be a long-term, not a short-term one.

BOX 3 SOUTH AFRICA

The Challenge and Political Will

After the relatively smooth transition of political power, the country faced immense economic challenges. By 1994, the South African economy was in a very poor state. Between 1990 and 1994 GDP had grown at a miserly 0.2% annually. Formal sector employment was declining, while government spending had risen to unsustainable levels. The apartheid government had run up massive debts trying to prop up apartheid and the crumbling Bantustan system. Borrowing had risen to the extent that the interest payments on the public debt were the largest budget item during this period. The country was skirting the edge of a debt trap that would have been very difficult to escape.

Fears of political transition also contributed to high levels of emigration of skilled professionals and an illegal flight of capital. Moreover, both domestic and foreign markets were far from convinced that the remarkable political transition could be matched in the sphere of economic management. At the time it was uncertain how the ANC, with its socialist heritage, would act when it took government. The high levels of inequality, endemic poverty and very poor human development indicators for the black population led many to believe the ANC would throw macro-economic caution to the wind and over-spend in an attempt to redress the imbalances of the past.

In order to achieve higher growth the new government needed to revive the private sector, while at the same time maximising employment growth and narrowing income differentials between blacks and whites. It needed to redress inequalities in access to public services and facilities, and in land ownership. It was equally apparent that with virtually no foreign reserves, a massive unfunded open position in foreign exchange, and an already overextended domestic debt burden and high domestic tax rates, little could be achieved through a further fiscal expansion… [As a result the political leadership committed itself to a number of reforms] in the process it also completely changed the structure of its public finances. Firstly, the structure of the state had changed. New spheres of government with newly defined functions and responsibilities were created. Secondly, there was a profound change in political priorities. Public resources had to be targeted to these new priorities. And thirdly, there was a profound change in attitude to governance: what had been a besieged police state had been transformed into essentially a liberal democracy operating under the rule of law.

The final Constitution contains a coherent, although not detailed, framework for the management of the country's public finances. This framework has laid the foundation for and guided the subsequent reform of PFM in the country, being fleshed out as it has by subsequent enabling legislation. Tracing the evolution of the governance arrangements between 1990 and 1996 therefore provides valuable insights into the fundamental characteristics of PFM reform.

Source: *Public Financial Management Reform A Case study of South Africa, 1994 to 2004. Commonwealth Secretariat. (In preparation) p 15 -16*

2.4 ESTABLISH AND EMPOWER KEY INSTITUTIONS

Guiding principles

1) ***Strong institutions are a prerequisite for good PFM:*** The institutions of government must be given a clear, non-contradictory legal mandate to operate effectively, as well as sufficient funding to secure the human capital they require to operate optimally. This means that clear rules of revenue division between different spheres of government (national, regional, local) and its institutions must be established. Special attention needs to be focussed on the funding and functioning of the planning department or budget office, treasury or other expenditure-controlling authority, revenue authority, the auditor-general, and parliament.
2) ***Institutional independence must be created:*** Sound financial management requires scrutiny by more than one party, where the one cannot control the conduct of the other. Public financial management is no different. Establishing independent institutions such as the office of an auditor-general is crucial to the integrity of the process. Similarly, an independent central bank should be able to guide monetary policy and act as a disciplining force on fiscal policy. Independence is never absolute, but institutions need to be independent within the overall strategic framework for the country and adequately resourced to achieve their specific mandate.
3) ***There must be clarity of mandate:*** Effective management requires that the mandate of an institution should be clearly defined and supported. A lack of clarity eventually causes conflict within government and a waste of resources.
4) ***Talented human capital is critical to build healthy institutions:*** If institutions are starved of people and resources to implement their mandates, the PFM process will not be effective. Government needs to pay market-related salaries for the appropriate resources, and structure training programmes to improve the skills of staff.

2.5 MANAGING REFORM

Guiding principles

There will always be a tension between the resources available for reform and constraints hindering it. The following guidelines are set out to minimise the constraints:

1) ***Take capacity where you can find it:*** Without the necessary systems and the skilled personnel to implement them, no PFM reform process can be successful. Financial management, whether in the public or private sector, is skills intensive. A developing country embarking on PFM reform must therefore harness all available expertise. There are two different dimensions to the process of harnessing expertise:

   a) *PFM "technology":* This is the existing body of international best practice. PFM is a science with well developed international norms and practices. It is not necessary to re-invent the wheel and a government can gain significant efficiencies by drawing on existing international best practice. Donors can play a very useful role in this process.

   b) *Human resources:* The appropriate human resources to lead, manage and implement the PFM reforms must be found and supported. Economic and financial management skills are scarce in most developing countries and governments compete with the private sector for these skills and they need to do so, on the basis of equal reward. Furthermore, there are pools of talent that can be better used:

      - *Incumbent civil servants* are the carriers of the existing institutional memory and knowledge. They are easily overlooked and threatened by change.
      - Every country has *private sector skills* to draw on. One of the most powerful ways in which this can be done, is to appoint experienced business leaders to the governing boards of state-owned enterprises.
      - *Academic and professional partnerships.* Government should enter into joint ventures with academic and professional bodies to establish public training courses and career placements as a way of filling talent gaps.
      - *Donor-funded technical skills* are available to virtually all developing countries.

Box 4 — Malaysia
Enhancing Human Resource to Support Reforms

The Malaysia Public service has been entrusted with the twin tasks of socio-economic development and nation building … in February 1991 the Rt. Hon. Prime Minister unveiled his *Vision 2020.* The Proclamation of Vision 2020 as the national aspiration to attain "a fully industrialised and developed nation status" within the next three decades ushers in a new chapter in the nation's continuing surge for greater heights in development.

To meet these challenges, the Malaysian Public Service has taken concerted efforts to introduce changes which cover a wide range of administrative improvements, the most notable of which is the adoption of a new mind-set and a new paradigm of thinking and doing things. The aim of these changes is to increase the capacity, capability and motivation of the work force to meet the challenges of rapid development in a constantly changing environment. The ultimate goal is to create an excellent Public Service. The Public Service is of the firm belief that the attainment of excellence hinges on the existence of a good value system. Cognisant of this fact, the Public Service has identified seven fundamental values deemed necessary for the attainment of an excellent Public Service. These are *quality, productivity, innovativeness, discipline, integrity, accountability* and *professionalism.* The assimilation of these values will contribute towards maintaining an efficient, effective, clean, trustworthy and disciplined Public Service that is also forward-looking and market-driven. It will also enhance the credibility of the Public Service in the eyes of the public and stake-holder. The inculcation and internalisation of these values are effected through the implementation of administrative reforms carefully planned and executed by the Government.

Source: *Current Good Practices and New Developments in Public Service management; a Profile of the Public Service of Malaysia; The Public Service Country Profile Series: No.3. Commonwealth Secretariat, 1995. p1-2*

2) ***Communicate pro-actively and deliberately:*** Successful communication is a key element of successful reform and should include:

a) *Citizens:* The starting point for a government's communication must be its own citizens;

b) *Government employees:* Successful PFM reform requires public servants to change behaviour. The public service is therefore a key target market for pro-active government communication and support during the process of change; and

c) *Domestic and international markets:* A government must utilise the signalling devices available to it to communicate to the international market. These vary from the quality of political and administrative appointments to the targeting of international ratings.

3) ***Invest in accurate, timely information and data collection:*** Accurate data and information is key to effective management. PFM relies on sound data not only about government's finances, but also about the international economy, domestic macro-economy, demography, standard of living and social conditions generally. Investment in an independent statistical capacity is an imperative to enhance PFM. This information services four functions:

a) To predict and collect revenue accurately;

b) To facilitate sound planning - reliable information provides the basis for planning;

c) To achieve efficient management - flexible and responsive management requires an ongoing flow of management information. For example, a monthly statement of government income and expenditure provides the backbone for just-in-time cash management which, if well managed, will reduce the loan requirement and eventually the government's debt burden; and

d) To facilitate the effective monitoring of outcomes. In other words does PFM actually make a difference to the people whom it is intended to impact? Do things change for the better? Accurate information gleaned from household surveys will indicate whether government's changed spending patterns and more effective management are hitting the target. Better information on delivery levels is the first step in moving to output- rather than input-focussed PFM.

4) ***Build relationships with donors:*** A number of principles need to be considered in dealing with donors since this community highly influences internal decision making processes and the operational parameters of policies. Some national budgets are largely donor supported, forming more than 50 percent of recurrent expenditure, which in turn requires donor recipients to meet benchmarks invariably worked out between the government and the donor. However, trends seem to shift towards the practice in which donors are becoming less prescriptive and are adopting country-led friendly arrangements around development assistance.

Donors have recently worked together to harmonise assessment instruments as well as strategies to work collaboratively with developing countries so as to keep reforms country-owned (see Appendix C).

The following principles are recommended for country interactions with donors:

a) Donor support should be factored in to the PFM reform strategy. This should be a programme co-ordinated between donors, which is coherent and multi-year that supports and is aligned with the PFM strategy. Donors can support government efforts but should never take responsibility for or be the drivers of reform – this should always lie with government;

b) Citizens of the pledging countries deserve to be treated with the same respect as a country's own citizens. Abuse or misuse of funds can and will lead to a withdrawal of support. In this respect, a government has an obligation to use its best efforts to raise domestic revenue before it turns to donors for funding;

c) Donor funding can provide a source of stability to the budget process in the long-term, and should as far as possible be co-ordinated through a single entry point so that full information on aid flows can be integrated into the budget;

d) Donors should try to minimise disruption to the functioning of the state and should co-ordinate to minimise complex and overlapping cross-conditionality. Ultimately, government has the responsibility for harmonising donor activity around its priorities, even as donors are encouraged to co-ordinate among themselves to avoid duplication. Government-chaired donor coordination groups on public financial management issues are one vehicle for helping harness donors to the Government reform agenda; and

e) Cloning of donor country initiatives and examples should never become a condition of donor funding.

2.6 MONITOR PROGRESS OF PFM REFORMS

Guiding principles

1) ***PFM requires rigorous monitoring and evaluating:*** Monitoring should cover the implementation of reform measures but also how institutional and systemic changes have been implemented. This can be achieved by embarking on sustainable review exercises with carefully established targets and outcomes over a specific period of time. The overall exercise requires:

a) Setting performance related benchmarks and indicators vis-à-vis the agreed objectives;

b) Empirical measurement of these benchmarks;

c) The production of a PFM performance report once every budget cycle; and

d) Measuring progress by assessing outcomes, rather than inputs or departmental activities.

Box 5 Canada
Programme Review

The Federal Government of Canada began a string of annual deficits in the fiscal year 1970 -71, contributing to a steady rise in the debt-to-GDP ratio from its post-war low of 18 per cent in 1974-75. By the end of 1992-93, the deficit had grown to over $41 billion (5.9 per cent of GDP), and the debt-to-GDP ratio stood at 67 per cent. By this point, there was growing awareness in the Federal Public Service, on international financial markets and among the Canadian public that the government needed to take swift and significant action – particularly by reducing expenditures.

The Liberal Party also recognised the need for reductions and promised, as part of their election platform, to reduce the deficit-to-GDP ratio to 3 per cent by 1996-97. This promise was followed in early 1994 by an announcement in their first budget that this objective would be achieved in part by reducing expenditures following a process of reviewing the spending of all departments.

This announcement led, among other things, to the Program Review exercise of 1994. Under Programme Review, the government examined $52million in direct programme spending (accounting for 32 per cent of overall spending) to assess the relative priority and cost-effectiveness of programmes, and ultimately to identify candidates for reduction and restructuring. A central feature of this examination involved asking six questions about every programme:

1. **Is it still in the public interest?**
2. **Is its delivery a legitimate and necessary role for government?**
3. **Is the current federal role appropriate, or should the programme be realigned with the provinces?**
4. **Should it be delivered in partnership with the private or voluntary sector?**
5. **Can it be redesigned for efficiency?**
6. **Is it affordable, given fiscal constraints?**

The results of the review, announced in the 1995 budget, were substantial: a total of $16.9 billion in savings over three years, reducing planned programme spending by almost 19 percent by 1997-98. A second Programme Review exercise was conducted in 1995, which led to the announcement of an additional $1.9 billion in savings over three years in the 1996 budget. These two sets of budget decisions (backed by effective and sustained review system) put the government on tract to achieve its deficit-to-GDP target of 3 percent by 1996-97, and even to achieve a further reduced target ratio of 2 percent by 1997-98.

Source: *A Profile of the Public Service of Canada, Current Good Practices and New Developments in Public Service Management (1992 -2002). Commonwealth Secretariat, 2003. p 84-85*

3. FISCAL FRAMEWORK ("WHAT")

Whereas the process framework sets out *how* to implement change, the fiscal framework sets out guidelines for best practice in PFM.

3.1 REVENUE COLLECTION

Guiding principles

1) ***Tax is essential:*** Tax establishes government's authority – government legitimacy is expressed in its ability to raise tax and its citizens' willingness to comply. Optimising domestic revenue collection is also a commitment that needs to be fulfilled before a government justifiably seeks additional funds or aid from donors. Consolidating and extending the revenue base and improving the efficiency of collection is essential to sound PFM.
2) ***The revenue services must be properly resourced and motivated:*** If revenue services cannot be made to operate efficiently the outlook is doubtful for other PFM bodies.
3) ***Policy is limited by external forces:*** In a globalised world, governments' choices are less about the tax rate than about the efficiency with which tax is collected and the reach of the tax net.
4) ***Optimising the revenue services depends on a number of factors:***
   a) Determining an appropriate tax policy for the country's specific economic development;
   b) Proper consultation and co-ordination between tax policy and tax administration departments;
   c) The tax administration should be empowered both legally (its ability to seek redress for non-compliance through the courts) and with respect to human capital (revenue services need properly motivated and managed staff);
   d) Adequate systems and data are needed to ensure accurate forecasting so that gaps between revenue forecasts and out-turn do not destabilise the fiscal framework;
   e) Transparency, predictability and fairness in the implementation and collection of tax and in the tax department's interaction with citizens;
   f) Ensuring full and timely accounting for all government revenues and receipts; and
   g) Effective control of arrears and write offs.

3.2 IMPROVE DEBT MANAGEMENT

Guiding principles

1) ***Government funding activities play a key role in determining the fiscal envelope***, in communicating government policy to the markets, and in determining the cost of borrowing in the economy as a whole.
2) ***Proper management of the government's borrowing program will reduce the cost of funding*** through reducing the level of risk and uncertainty associated with investing in government stock.
3) ***Sound principles for deficit funding should be established*** and are crucial to effective PFM and macro-economic policy. These should include the following:
   a) The public debt burden should remain sustainable, not only for the present, but also future generations;
   b) A clear and sustainable deficit target for the short, medium and long term should be established;
   c) Prudential guidelines to manage contingent liabilities with respect to government guarantees, the government employee pension fund, debt consolidation to minimise costs, and parastatal borrowing should be set;
   d) Departments should not incur financial or contingent liabilities that attempt to leverage a departmental budget above that which was intended in the budget approval process;
   e) Governments need to build a sound framework for managing contractual relationships at a departmental level and within state owned enterprises;
   f) The accumulation of arrears is the same as overspending and should attract the same penalties;
   g) Cash should be managed wisely across the public sector;
   h) Transparency and predictability in funding should be optimised – there should be tight record-keeping and controls to manage obligations as well as full disclosure of arrears and contingent liabilities;
   i) Borrowing should seek to enhance liquidity through benchmark bond issues, maintain a full yield curve, and achieve an appropriate balance between domestic and foreign currency borrowings; and
   j) Finally, government should ensure that capital expenditure can be supported over the long term by recurrent budget allocations.

3.3 IMPROVE PLANNING PROCESSES

Guiding principles

1) Planning is the logical organisation of activities towards the achievement of national objectives while budgeting (the next section) is the financial representation of this plan. The demand for public goods will always exceed the supply. Effective planning and allocation of resources is therefore critical.
2) Best practice in expenditure planning requires that:
   a) Governments should develop and institutionalise planning processes at all levels of government;
   b) Planning needs to be based on realistic expectations concerning the future availability of resources;
   c) Government should create the capacity to manage the public private interface and to leverage private sector activities in the meeting of public objectives;
   d) Plans should be flexible and revisited periodically as circumstances change and plans fall out of date;
   e) Planning needs to be based on sound information on current expenditure trends, and address short (next budget), medium, and long-term issues;
   f) Public outcomes are mostly long-term outcomes. To change the outcomes therefore requires aligning the planning horizon with the length of the change process itself;
   g) Lengthening the time horizon requires bringing other stakeholders on-board because successful PFM reform, which results in a big impact for the society as a whole, usually requires implementation over a period that extends beyond the life of one democratically elected parliament (given the average prevailing electoral term). Bipartisan political commitment to the process would therefore ensure full implementation even though there may be a change of government; and
   h) The issues identified during planning need to be appropriately reflected in the budget stage.

3.4 IMPROVE BUDGETING

Guiding principles

1) There are a number of principles that should be respected in the budget process:
   a) The budget should reflect overall economic policy (both in focus and scale);
   b) The budget must be accurate, informative, and comprehensive. It must encompass all government revenues and expenditures;
   c) Aggregate expenditure out-turn and its composition should not consistently diverge from budget, and sanctions should be in place for budget overruns;

d) The budget should include a discussion of public liabilities, assets, employee pension obligations, tax and non-tax revenues, as well as details on public expenditure categories;

e) The annual and/or multi-year budget should be based on a medium- to long-term framework. This greatly enhances predictability in departmental allocations and has a positive impact on planning and execution within government;

f) The budget should be participatory and transparent. It should include all stakeholders, including civil society, private sector consultations and parliamentary public hearings, as well as full and open media coverage;

g) The budget cycle should provide sufficient time for informed discussion by parliament;

h) Comprehensive information on the budget and its out-turn should be widely available within a reasonable timeframe to inform debate;

i) Expenditure management processes should assign clear responsibility from the political head of a department responsible for policy matters and outcomes to the head official (Director General or Permanent Secretary) responsible for outputs and implementation and ensuring that funds are not wasted or stolen; and

j) There must be a monitoring of progress. Budgeting should be focussed on ensuring better outcomes, not on inputs.

3.5 STRONG BUDGET IMPLEMENTATION, ACCOUNTING AND REPORTING

Guiding principles

1) Managing the implementation of the budget and expenditure management processes are essential to the credibility of PFM.

2) A number of principles must be respected in implementing the budget:

a) The budget must be approved by the legislature prior to implementation;

b) Implementation must comply with accounting and financial management laws;

c) Implementation should ensure good performance and value for money in government operations, and should cut government cost and wastage;

d) Successful implementation requires capacity and capacity development, especially training in modern public financial management techniques;

e) The office of the Accountant-General must be properly resourced and funded to fulfil its function. This role includes: providing clear definition of reporting responsibilities; day to day cash management; co-ordination with committees responsible for overall cash and debt management; preparation of the annual report and accounts of government in a timely manner; and compliance with accounting norms and standards;

f) All government expenditures should be accounted for in a timely manner and significant deviations from budget estimates should be investigated; and

g) Clear rules regarding the format, frequency and timing of financial and operational reporting and clear reporting standards should be established.

Box 6 — Australia
Performance Reporting and Benchmarking

Budget appropriations are made for outcomes, and the Portfolio Budget Statements identify these together with the associated outputs and administered items. At budget time, performance indicators are also published, often accompanied by targets for planned performance, with the onus on agencies to report publicly (in annual reports) within four months of the end of the relevant financial year on actual performance against these indicators. Any changes made during the year to the suite of indicators must be explained, together with material performance variations between predictions and results. Both at budget time and following the end of each year, Ministers, agency heads and their agencies are subject to a well-developed process of parliamentary scrutiny.

This consistency in reporting at year-end against the same outcomes, outputs, administered items and associated indicators, identified earlier at budget time, is valuable in clarifying accountability. This performance management regime has been reinforced by other initiatives, such as market testing, outsourcing, purchaser-provider and business partnership arrangements, and privatisation. In situations where agencies deliver services directly to the public, they are also expected to implement and report against service charters.

Source: *A Profile of the Public Service of Australia, Current Good Practices and New Developments in Public Service Management (1992 -2002). Commonwealth Secretariat, 2004. p89.*

3.6 PROCUREMENT

1) ***There should be clear rules on open and accountable procurement policies based on the following principles***:

a) A centralised procurement authority should be set up to be responsible for bringing about an efficient and effective procurement system into government. Procurement decisions based on these rules should be decentralised to the bodies for example, line ministries responsible for funding the procurement;

b) Procurement laws should be reviewed to meet best practice criteria;

c) Procurement guidelines must be put in place that are consistent with principles of transparency, fairness, openness and value for money;

d) Sanctions must be implemented for non-compliance with regulations; and

e) There should be strictly scrutinised and accountable procurement procedures, for example, with regard to tender processes.

3.7 STRONG INTERNAL AND EXTERNAL OVERSIGHT

Guiding principles

1) ***Effective oversight and monitoring are crucial to sound governance and PFM reform.*** A well functioning PFM system must have clear rules on transparency and reporting, as well as enforceable sanctions for failure.
2) ***Oversight should take place both internally and externally.*** This generally means shifting the locus of control from outside to inside the organisation.
3) Guiding principles for internal oversight should be:
   a) Internal oversight should come from the Ministry of Finance: the Ministry of Finance should be given oversight responsibility over all line ministries, departments and agencies in the budget and implementation process, which, in turn, should have adequate, current and timely information and data to manage their own finances and to provide the Ministry of Finance with records;
   b) Internal oversight includes the internal audit function which must be effective and should comply with generally accepted auditing standards with regards to staffing, planning, and reporting. Internal audit mechanisms should ensure that:
      - Spending is within budgetary provisions;
      - Disbursements comply with specified procedures;
      - Dual control is employed in processing transactions;
      - There is a timely reconciliation of accounts;
      - Sanctions for non-compliance are defined and applied;
      - Effective systems for managing physical and financial assets are developed;
      - Adequate management reporting systems are in place; and
      - From time to time, random operational performance audits are carried out.

Box 7 — Singapore
Internal Auditing

It is increasingly recognised that internal audits can be useful as a tool of management, and help organisations to increase effectiveness and efficiency in addition to improving financial controls and procedures.

The Public Accounts Committee has also, as far back as 1979, felt that ministries should consider assuming responsibilities for self-policing by setting up internal audit units to supplement the functions of the Auditor-General. It also recommended that internal audit units be set up in the more important revenue collecting departments and those with larger expenditure votes. The Committee also recommended that medium and large statutory boards establish internal audits as soon as practicable. In 1986, it also recommended that the internal audits extend their scope of work to value-for-money auditing, where it was not already being done.

Ion seeking to improve the effectiveness and efficiency of internal audits, some basic areas would need to be addressed. These include:

a. Role of the internal auditor
b. Independence
c. Scope of work
d. Staffing
e. Organisation and management

To achieve good internal auditing that can fulfil the needs of management and serve as a basis for managerial decision-making, the internal auditor should be independent. He should carry out his work freely and objectively, and make impartial and unbiased judgements.

To achieve independence, the internal auditor should have access to the administrator who can take appropriate action to correct problems as they are discovered and reported. He should not be placed under the chief financial officer whose work is under the internal auditor's constant review. The internal auditor should also have access to the Permanent Secretary, board members or audit committee so that significant issues and unrectified problems can be brought to their attention. This would signal top management's commitment to organisational efficiency and effectiveness.

There should not be any significant restrictions on the work of the internal auditor if he is to act as an effective tool for management control. He should not be given direct operating responsibilities, e.g. making operational decisions and designing systems.

Strengthening the internal audits is a continuing process, and over the years, internal audits have continued their progress. Currently, many of the internal audits have used computer audit software to help increase effectiveness and efficiency. They have also undertaken assessments of audit risks and controls.

Source: *Current Good Practices and New Developments in Public Service Management – A Profile of the Pubic Service of Singapore. Commonwealth Secretariat, 1998. P 101 – 102.*

4) Guiding principles for external oversight are:

a) ***There should be parliamentary oversight of PFM:*** This should take place in a number of ways: through the tabling of documents; debates and questions; raising and explanation of PFM issues; and through the operation of parliamentary finance committees who are empowered to oversee budget formulation and appropriation, implementation of policies and outcomes of budget allocations. All forums should be open to the media and public. Parliament itself should be independent, adequately resourced, and should have knowledgeable members with sufficient resources at their disposal to be able to interrogate PFM issues.

b) ***The Standing Committee on Public Accounts should be afforded a special status***, including that its chairperson be drawn from the largest opposition party and its members have financial acumen. It should ensure value for money in PFM through results and outcomes. The resources for such a committee should be greater than for other committees, given that it should be independently able to interrogate both the reports of the Auditor-General and the affected departments or entities being reported on. Examining the Auditor-General annual financial reports is crucial not only for PFM but also for governance *per se*.

c) ***The public must be given effective redress through the office of the Ombudsman or similar channel*** for the settlement of complaints relating to PFM without having to rely on recourse to the courts. This office must provide protection and security of tenure to public officers in the performance of their duties, without being exposed to the intimidation of political pressure from other public officials.

d) ***Oversight can also come from international bodies*** like the IMF, Transparency International, the Bank for International Settlements, IOSCO, and the International Committee for Bank Supervisors, all of which reinforce effective oversight and best international practice. Being members of such bodies, and participating in their various working groups and technical committees enhances skill development and accountability.

e) ***The media and civil society should be regarded as PFM stakeholder institutions*** and should be encouraged to play a role in bringing to light failures and successes of PFM. The media should be allowed to engage in open dialogue with officials and have access to the sittings of parliament and meetings of the Committee on Public Accounts. Moreover, the press should be timeously and well briefed around the time of the budget so that the public is informed of developments and problems, if any, in budget and spending allocation. Funds should be allocated for the education of the public on the budgetary processes.

All stakeholders including, civil society, the private sector and professional institutions must be proactively engaged in the process or reform and provided

with the requisite incentives to participate in the laying of the foundation of workable infrastructure, good governance and deliverable policies.

Box 8 India
Establishing Partnerships with Stakeholders and User Groups

One of the dimensions of a proactive government is the emergence of public-private partnerships and support for the initiatives of the poor, city level planning, economic enterprises and transport. Partnerships broaden the range and deepen the base of participation at local and neighbourhood level. Partnerships in India are horizontal and vertical, government-led and citizen-driven, depending on who takes the role.

Partnerships with voluntary agencies, financial institutions and stakeholders are structured into many centrally sponsored programmes and externally aided projects for social services, poverty reduction and infrastructure. There are many city level partnerships of municipal councils and citizen groups for shelter upgrading, slum improvement, health care and waste management, such as EXNORA in Channai. The private sector is increasingly a part of such partnerships where it can provide both managerial skills and in-fill finance. Professional managers from associations to validate and spread innovations as in the case of the city Managers Association, the All India Mayors Council and the All India Management Association.

Source: *A Profile of The Public Service of India, Current Good Practices and New Developments in Public Service Management. Commonwealth Secretariat, 2004. p152*

f) ***The Auditor-General should be the external auditor of all government affairs.*** The Auditor-General should be independent and subject only to the rule of law so that functions can be exercised without fear or prejudice. No political person should interfere with the functioning of the Auditor-General. To protect its independence the Auditor-General should be nominated and approved by parliament, and should report to an audit commission (consisting of members and non-members of parliament), not to the executive. The Office of Auditor-General should be well funded and well staffed and physically housed in separate and independent offices to any part of the executive. The Auditor-General should have an advisory board to assist in the performance of duties and to provide technical support. This should not limit the Auditor - General in relying on the work of external auditors or of internal auditors.

g) Procedures should be in place whereby judicial enforcement may be exercised by the courts to ensure that the provisions of the public finance administration act and regulations are fully respected and adhered to.

Box 9 Australia
Strengthening Accountability

The Role of the Auditor General

The Auditor-General Act 1997 **sets out the main responsibilities and information gathering powers of the Auditor-General, as well as establishing the Australian National Audit Office (ANAO). In contrast to the Audit Act 1901, which it replaced, the Act focuses on audit goals rather than processes and better defines the status of the Auditor-General and the role of the ANAO**

The Auditor-General and the ANAO play a key role in monitoring and reporting on the performance and accountability of the Commonwealth public sector in its use of public resources. The role extends to providing guidance and leadership in relation to some elements of good government.

As an independent officer of Parliament, the Auditor-General, appointed for a term of ten years, is not subject to control or direction by any individual Minister or other Member or Senator of Parliament, and has the ultimate responsibility for setting the scope of his or her activities. Independence is reinforced by the application of parliamentary privilege to performance and financial statement audit reports tabled in the Parliament. This privilege can operate to protect the Auditor-General and ANAO staff from being held liable for statements contained in audit reports. This allows the Auditor-General to report freely, openly and responsibly on matters examined in the course of audits.

Financial Statement Auditing

The preparation of financial statements by Commonwealth organisations to report on their financial position and financial performance has become a universally established part of normal financial management in the last decade. Annual financial statements are subject to external audit by the Auditor-General.

The auditor's report provides an independent examination of the financial statement in order to express an opinion as to whether the statement is prepared in accordance with auditing standards and other mandatory professional reporting requirements. The audit report is included in the agency's annual report, which becomes a public document when it is tabled in Parliament, provides assurance to the Parliament and other stakeholders of the financial position of the organisation. It also provides an appropriate level of transparency and accountability in the management of the Commonwealth's financial affairs.

Source: *A Profile of the Public Service of Australia, Current Good Practices and New Development in Public Service Management. Commonwealth Secretariat, 2004. p79*

Conclusion

These Guidelines have outlined processes and practical requirements for reforming public finance management with emphasis that the contents can be modified to reflect local dynamics. However, we would like to send an important message to policy makers that reforms, especially those dealing with the management of public funds can be threatening to both reformers and their populace. In this sense, resistance to change, slow yielding of reforms and constant change in the national and international environments pose challenges that must be managed with requisite flexibility and sterner measures.

We would also recommend that developing countries create PFM partnerships with their developed counterparts both from within and without the Commonwealth to support and sustain the reform process. Relationships of this nature might, for example, accelerate the integration of ICT, which is an important component of modern public sector reforms into national PFM framework. Forging partnerships with developed counterparts will, in other words, transfer pyramids to the valleys (skills transfer from high capacity to low capacity areas).

Finally, we have provided a pool of reading material in the reference section to aid our readers interested in further research in this discipline. It must be reemphasised that PFM is a "technology" that is in need of constant review and renewal to keep the reform current and productive.

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APPENDIX A

Extract from the Aso Rock Commonwealth Declaration on Development and Democracy: *Partnership for Peace and Prosperity*

1. We, the Heads of Government of the Commonwealth of Nations, meeting at Abuja, Nigeria from 5 to 8 December 2003, commit ourselves to strengthen development and democracy, through partnership for peace and prosperity. Building on the landmark Declarations in Singapore, Harare and Fancourt, we are committed to democracy, good governance, human rights, gender equality and a more equitable sharing of the benefits of globalisation.

2. We recognise that the Governments of the Commonwealth are partners sharing a fundamental responsibility for the development, security and well-being of their people. We acknowledge their central role in guaranteeing stability, good economic management and governance in promoting sustainable growth and development.

3. We welcome the Report of the Commonwealth Expert Group on Development and Democracy which was constituted following the 2002 Coolum CHOGM. We have noted its key recommendations for Commonwealth actions, focusing on how democracies can best be supported in combating poverty.

4. We believe that efforts aimed at eradicating poverty and improving governance are essential for greater international equity and global peace and security. We recognise that the Millennium Development Goals (MDGs) have mobilised governments, international institutions and civil society to reduce poverty with renewed vigour and commitment.

5. We recognise that globalisation has significant potential benefits for all. However, the world is characterised by uneven development, and we therefore stress that globalisation must provide real opportunities for developing countries to transform their economies and societies through diversification for the benefit of their people. It is the strategic goal of the Commonwealth to help their pre- industrial members to transition into skilled working- and middle-class societies, recognising that their domestic policies must be conducive to such transitions.

6. We further recognise that while development and democracy are goals each in its own right, they must be mutually reinforcing, with a clear 'democratic dividend', in terms of delivering tangible benefits to people. We are convinced that broad-based prosperity creates the stability conducive to the promotion of democracy; and that strong democratic institutions better promote development.

7. Accordingly, we commit ourselves to make democracy work better for pro-poor development by implementing sustainable development programmes and enhancing democratic institutions and processes in all human endeavours. We recognise that building democracy is a constantly evolving process. It must also be uncomplicated and take into account national circumstances. Among the objectives we seek to promote are the following:

i. a participatory democracy characterised by free and fair elections and representative legislatures

ii. an independent judiciary

iii. a well-trained public service

iv. a transparent and accountable public accounts system

v. machinery to protect human rights

vi. the right to information

vii. active participation of civil society, including women and youth

viii. substantially increased and more effective financial resources

ix. adherence to the internationally agreed targets of 0.7 percent of GNP for development assistance

x. financing and realisation of the Millennium Development Goals (MDGs)

xi. increased democracy at the global level, including enhanced participation and transparency in international institutions

8 December 2003

APPENDIX B

Supporting Better Country Public Financial Management Systems: Towards a Strengthened Approach to Supporting PFM Reform
(By the Joint World Bank/IMF/PEFA Public Expenditure Working Group)

A. INTRODUCTION

1. **Effective PFM systems are crucial to countries making progress in reducing poverty**. This connection – between PFM systems and poverty reduction – was given added attention with the introduction several years ago of the HIPC debt relief initiative. Most of the Poverty Reduction Strategies (PRSs) that partner countries have developed recognize that sound PFM supports aggregate control, prioritization, accountability and efficiency in the management of public resources and delivery of services, which are critical to the achievement of public policy objectives, including achievement of the Millennium Development Goals (MDGs). In addition, sound public financial management systems are fundamental to the appropriate use and effectiveness of donor assistance since aid is increasingly provided through modalities that rely on well-functioning systems for budget development, execution and control.

2. **A decade of intensive diagnostic and analytic work undertaken by IFIs, donors and countries[3] has generated an unparalleled body of information and knowledge on the operation of public financial management (PFM) systems throughout the world, but an increased focus on implementing reform is now required.** The diagnostic work has been undertaken to support development of public financial management reform programs that now exist in countries throughout the world and also meet the need of donors to collect information to assess fiduciary risks, inform decisions about aid modalities and design appropriate safeguard measures. While some progress has been made, assessments such as the EC's audits and the joint World Bank/IMF work in HIPC expenditure tracking demonstrate that major weaknesses remain in many countries. Efforts to improve public financial management systems are therefore entering a new phase of work. With reform programs in place, the proposed approach reflects the need to shift country and donor focus from understanding organizational and systemic strengths and weaknesses to implementing reform and improving performance.

3. **Innovations in assisting countries' establish effective public financial management systems are taking place in different countries.** These include greater government involvement in diagnostic processes, more integrated and coordinated assessments, support for integrated and sequenced action plans, and recently to better understand the impact of governance and incentives on the performance and reform of the PFM systems. Approaches to assessing fiduciary risks are also evolving. While each donor continues to have their own criteria and thresholds when assessing fiduciary risks and taking decisions concerning the modality and quantity of its aid, increasing attention has recently been placed on partner

[3] Including through the World Bank's Country Financial Accountability Assessments (CFAAs), Country Procurement Assessment
Reviews (CPARs), and Public Expenditure Reviews (PERs), the EC's audits, and the IMF's Fiscal ROSCs, some or all of which have been performed in a large number of developing countries.

countries' interest in strengthening their PFM systems and on the actual progress achieved rather than simply focusing on the level of PFM performance at any given time.

4. There is a need to capture the useful innovations that have arisen within a framework that enhances effective collaboration among the international community and governments. The modifications that have been made in supporting improvements in public financial management and addressing fiduciary needs have been important but remain partial. Progress has been made in improving country participation but diagnostic instruments are often still deployed to respond to donor and IFI timelines and schedules. The increasing use of budget support has given rise to an entirely new set of ad hoc fiduciary evaluations and analyses that burden country officials and threaten to create another source of conflicting policy recommendations and advice. As a result, problems now exist not in the absence of reform programs but in their proliferation, with each plan supported by a web of different conditionalities demanded by different donors and IFIs, and related technical support, amidst a tangle of conflicting claims to legitimacy and country ownership. In many countries, it is not unusual to find five or more different action plans in various stages of implementation all designed to enhance financial management. While countries increasingly speak about achieving results, there exists no consistent framework for them or for donors to evaluate the workings of their systems or the progress that has been made to achieving better performance. In sum, there is a need for the creation of a platform that could serve as a common point of dialogue between government and donors, and among donors, that would assist in managing the developmental and fiduciary dimensions of public financial management reform.

5. **This note sets out a proposed approach to supporting improved public financial management performance through aligning donor and IFI assistance to country-led programs of work**. This approach has been developed by the World Bank and the IMF together with the Public Expenditure and Financial Accountability (PEFA) program[4], and in consultation with the OECD-DAC Joint Venture on Public Financial Management. It identifies a flexible approach to building constructive partnerships among countries, donors, and IFIs focused on delivering results on the ground.

6. **Building upon lessons and good practices from existing work, the Strengthened Approach is designed around three central tenets**:
(a) Modernizing and increasing the effectiveness of public financial management systems is an activity for governments. Donors can support these efforts but they are not a substitute for government leadership, and should not undermine domestic accountability arrangements.

(b) Enhancing the capacity and performance of public financial management systems requires a government-led strategy that is sequenced in accordance with country circumstances, takes account of institutional, managerial, and technical issues, and is supported by donors in a coherent, coordinated, and programmatic manner; and

[4] PEFA is a partnership between the World Bank, European Commission, UK Department for International Development, Swiss State Secretariat for Economic Affairs, French Ministry of Foreign Affairs, Norwegian Ministry of Foreign Affairs, the International Monetary Fund, and the Strategic Partnership with Africa.

(c) Rigorous and consistent monitoring and evaluation of accomplishments is essential for managing reform, for the creation of effective accountability for reform success and to inform donors' evaluation of the evolution of fiduciary risks.

The Strengthened Approach

7. **The strengthened approach reflects the principles that guide all international support for development.** The Monterrey Summit of 2002 proposed a new partnership based on mutual responsibility and accountability between developed and developing countries in support of sound policies, good governance and the rule of law.[5] The summit emphasized the principle that each country has primary responsibility for its own economic and social development.

8. **The strengthened approach has three components**:

• A country-led agenda - a country led PFM reform strategy and action plan

• A coordinated program of support- a coordinated IFI-donor integrated, multi-year program of PFM work that supports and is aligned with the government's PFM strategy.

• A shared information pool – a framework for measuring results that provides consistent information on country PFM performance, including progress over time.

9. **A country-led agenda - A country-led PFM reform strategy and action plan**. The starting point for public financial management reform is a country-owned program of reform[6] and a country-owned structure for managing the reform process. Country ownership and leadership are critical to successful reform, and the strengthened approach involves development of effective partnership between government and donors to support country ownership. In developing a country-led reform program, important considerations for all stakeholders are that the program is prioritized and feasible, and builds from the country's current circumstances and capacities.

10. **A coordinated program of support - A coordinated, integrated IFI-donor multi-year program of PFM work that supports and is aligned with the government's strategy and budget processes.** Country-led reform programs should form the basis for IFI-donor support. Donor support will include assistance for diagnosis, development of feasible, sequenced action plans, and support for implementation with a clear focus throughout on the goal of capacity development. The program of support should be integrated across the PFM agenda and activities should be aligned with government budget and reform cycles. An effective donor coordination arrangement should streamline the dialogue between government and donors, facilitate donor support to the government budget and PFM reform processes,

[5] See *Report of the International Conference on Financing for Development*, Monterrey, Mexico (United Nations, A/CONF.198/11),
March 18-22, 2002.

[6] This may not be captured in a single document, particularly at the outset of reforms when government may wish to commence in a specific area before considering a broader reform program. The critical issue is not comprehensiveness since they may lead to over planning but that there is government ownership and commitment to the reforms, for coherence between different elements, and for donor alignment

maximize the sharing of knowledge, and provide a collective framework for managing donor activities. Such an arrangement requires donors to recognize each other's expertise to allow assignment of specific and non-duplicative roles. Collaboration among IFIs-donors would recognize the distinct competences of different donor agencies, and seek to integrate work into a coherent program delivered by a broad-based team. In countries such as Cambodia Vietnam, and Indonesia, great strides are being made in achieving consensus on the roles of different donors

11. **Ideally, a yearly program of support would be defined based upon a dialogue between the government and donors in a government-led forum** – a practice that currently exists in countries such as Mozambique and Tanzania. Support programs would utilize all tools at IFI/donor disposal, including further diagnostic, analytical or advisory work, technical assistance, lending or grants, in-kind support, etc. Though further analytical work might be part of a Government's action plan, the focus would be on capacity building. The emphasis on long-term capacity development would also likely influence the methods of assistance, with greater use of techniques such as partnering, twinning, and other methods designed to ensure organizational change and increased institutional acceptance of a performance-oriented ethic.

12. **Commitment to a coordinated program of PFM work in support of a country strategy is complemented by making use of a country's financial systems to the greatest extent feasible in all forms of aid delivery** Alignment of donor-IFI support with country strategies can also be advanced through the method of providing financial assistance, as well as the financial arrangements surrounding foreign assistance. Rationalizing and coordinating donor practices, such as reducing the need for separate financial and accounting arrangements for donor funds, is important in order to free up scarce human resources needed to implement public financial management programs.

13. **A shared information pool - The final feature of the approach is a monitoring system that provides objective and consistent information on public financial management performance over time**. Until now, there has not been a framework for countries or IFIs-donors to determine the degree to which reforms are yielding improved performance. The absence of reliable information using a consistent set of indicators has created problems for the management of reform and has retarded the ability to identify and learn from reform success. Moreover, the lack of objective information has led to a variety of invasive diagnostic efforts undertaken by donors and IFIs required to satisfy their own fiduciary requirements. To interrupt this costly practice, a system capable of providing such information in a credible manner is therefore needed.

14. **Different arrangements may exist for PFM performance measurement and monitoring depending on country circumstances and accountability requirements of donors**. Some countries, including some middle-income countries may have reasonably robust systems for measuring and monitoring results which could be relied upon by donors. In many other countries, such systems may need to be progressively put in place justifying the need for a credible, externally validated assessment of PFM performance. To facilitate this, IFIs and donors have jointly developed an integrated PFM performance monitoring framework, on which consultation is taking place with partner government and other stakeholders, that covers all aspects of the budget cycle including budget formulation and

execution, procurement, accounting, auditing and internal and external controls. The framework, which is currently being tested, includes a common set of indicators (attached at annex 1), and an accompanying analytic report, which could provide a common platform for dialogue between government and donors regarding the current performance, recent progress and development of a single action plan for reform and capacity development . This PFM performance report would describe the country context and environment for reform, elaborate more fully on performance as measured by the indicators, comment on progress with the implementation of the reform program, and judge its likely impact.[7] It would be informed as far as possible by available analytic work on the country's PFM systems. The cooperation of government would, of course, always be important, but the nature of the involvement may vary depending on country preferences and circumstances. The government may undertake an initial self assessment, the donors and government may undertake the process together, or the government may just provide information. The assessment would be externally validated by donors to ensure that a credible and objective assessment results. The assessment of the donors should be shared with government and any difference of view clearly recorded. The report's high-level indicators could be supplemented as needed by detailed indicators on specific aspects of the PFM system. Procurement is one area in which detailed, drilled-down indicators have also been developed. The indicators and the report would be modified and adapted as needed based on field testing and implementation experience. To recognize diverse country conditions, some customization may be appropriate (including for sub-national levels, where required), although it is important that the indicators remain constant over time to allow progress to be monitored.

Taking Forward the Strengthened Approach

15. **The proposed approach could represent a significant evolution of support to PFM systems that can be characterized as moving from diagnostics to implementation.** The next step is implementation on the ground, and. This involves tailoring the approach to country circumstances in order to support country-led reform, changes in the nature of country-donor interactions, and internal changes within donor organizations to support improved donor practices on the ground. Further dialogue with partner countries and donors is taking place. In implementing the approach, critical challenges for countries and donors include the following:

• Aligning donor support to country priorities – an issue that requires consideration of how to increase the flexibility of donor interventions.
• Tailoring analytical work to meet country needs – an issue that entails reducing and streamlining analytical work to eliminate duplication and standardization.
• Streamlining the content and coordination of donor conditionalities and support – an issue that requires the establishment of effective structures for donor collaboration, as well as the creation of organizational incentives to promote better integration of technical or advisory assistance.
• Ensuring a credible assessment of PFM performance over time as an information pool for donors to draw upon for their fiduciary assessments.

[7] Country-specific issues e.g., extractive industries, or aspects of the PFM system requiring special attention could also be covered

PFM Performance Indicators

A. PEM OUT-TURNS
1. Aggregate fiscal deficit compared to the original approved budget. 2. Composition of budget expenditure out-turn compared to the original approved budget. 3. Aggregate revenue out-turn compared to the original approved budget. 4. Stock of expenditure arrears; accumulation of new arrears over past year.
B. KEY CROSS-CUTTING FEATURES : COMPREHENSIVENESS AND TRANSPARENCY
5. Comprehensiveness of aggregate fiscal risk oversight. 6. Extent to which budget reports include all significant expenditures on central government activities, including those funded by donors. 7. Adequacy of information on fiscal projections, budget and out-turn provided in budget documentation. 8. Administrative, economic, functional and programmatic classification of the budget. 9. Identification of poverty related expenditure in the budget. 10. Publication and public accessibility of key fiscal information, procurement information and audit reports
C. BUDGET CYCLE
Medium term planning and budget formulation
11. Extent of multi-year perspective in fiscal planning, expenditure policy-making and budgeting, including procurement. 12. Orderliness and participation in the budget formulation process. 13. Coordination of the budgeting of recurrent and investment expenditures. 14. Legislative scrutiny of the annual budget law.
Budget execution including procurement
15. Effectiveness of cash flow and procurement planning, management and monitoring. 16. Procedures in operation for the management and recording of debt and guarantees. 17. Extent to which spending ministries and agencies are able to plan and commit expenditures in accordance with original/revised budgets. 18. Evidence available that budgeted resources reach spending units in a timely and transparent manner. 19. Effectiveness of internal controls, including on procurement. 20. Effectiveness of internal audit, including on procurement. 21. Effectiveness of payroll controls. 22. The existence of a transparent procurement system as an integral part of the overall PFM system which is supported by a clear regulatory framework that provides for competition, value for money and effective controls.
Accounting and reporting
23. Timeliness and regularity of data reconciliation. 24. Timeliness, quality and dissemination of in-year budget execution reports. 25. Timeliness and quality of the audited financial statements submitted to the legislature.
External accountability, audit and scrutiny
26. The scope and nature of external audit. 27. Follow up of audit reports by the executive or audited entity. 28. Legislative scrutiny of external audit reports.

In addition to indicators of country PFM performance, this framework also includes two indicators of donor practices which impact country PFM systems. Through these indicators, donor performance and the extent of the negative impact of donor practices, are also measured.

Indicators of donor practices
Donor 1. Completeness of donor information provided on aid flows, and comparison of actual donor flows with donor forecasts.
Donor 2. Proportion of aid that is managed using national procedures

For each of the high-level indicators listed above, detailed explanation and guidance on scoring (A-D) has been developed.[8] This set of high-level PFM indicators could be supplemented as needed by detailed indicators on specific aspects of the PFM system. An example is the set of indicators that have developed and presented by the OECD-DAC and World Bank Roundtable on procurement.

[8] The explanation and guidance for each of the indicators is contained in *PFM Performance Measurement Framework, Revised Consultative Draft, October 21, 2004*, which can be found at www.pefa.org.

APPENDIX C

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