



Public Finance Management in Development Co-operation

– A Handbook for Sida Staff



SIDA MANUAL

This handbook is a result of the special initiative on Public Finance Management launched by the Director General in 2004.

It underlines the importance of PFM for poverty reduction and gives concrete advice on how PFM issues can be handled in the development cooperation.

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Public Finance Management in Development Co-operation

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Foreword

The purpose of this handbook is to support the everyday management of development cooperation to deal with issues related to public finance management (PFM). The handbook supports the use of *Sida at Work*, and complements it by showing how PFM affects development cooperation. Its ambition is thus to provide concrete advice for the implementation of Sida's operational tasks by presenting answers to what to think of and how to do it.

Looking at a specific development activity in isolation is not feasible. The outcome of support will be determined by macro and sector policies, the ability of the PFM systems to support the implementation of these policies, and capacity issues within and beyond the sector.

Consequently, the Policy for Global Development, the harmonisation agenda and the new aid architecture translate into a considerable higher focus on public finance management. Contributing effectively to poverty reduction entails effective management of PFM issues.

The guidelines respond to many issues in relation to central elements in Sida's management of its development cooperation activities and are intended to be a working tool for:

- understanding how weak PFM systems constitute constraints to efforts to reduce poverty;
- addressing PFM weaknesses while developing the capacity of the systems;
- the assessment of PFM in partner countries including choice of appropriate financing modalities and other strategic questions where the status of PFM matters;
- dealing with PFM issues in the appraisal, design, management and follow-up of contributions;
- implementing the Paris Declaration on Aid Effectiveness, particularly as regards alignment with national systems.

The guidelines have been structured in accordance with the main Sida processes to make it easy for the reader to directly find guidance. There are thus separate chapters to consult depending on whether you are working on a new cooperation strategy, preparing sector programme support, or working on PFM reform. Apart from a brief introduction to the PFM system and its general features, you will find more detailed descriptions of the different sub-subsystems and issues to consider in the chapter on PFM assessments and the appendices.

The handbook is important for a wide range of Sida staff. I therefore hope that you will use it as a supportive tool in your daily work.

Staffan Herrström

Head of Department for Policy and Methodology

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Acronyms

AIA	Appropriation in Aid
APPs	Assessment and Action Plans
ARTF	Afghan Reconstruction Trust Fund
CFAAs	Country Financial Accountability Assessments
CG	Consultative Group
CoC	Code of Conduct
CPAR	Country Procurement Assessment Report
CPIA	Country Performance and Institutional Assessment
DAC	Development Assistance Committee
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
FRA	Fiduciary Risk Assessment
GBS	General Budget Support
GDP	Gross Domestic Product
GFS	Government Financial Statistics
HIPC	Heavily Indebted Poor Countries
HR	Human Resource
HRM	Human Resource Management
IASB	International Accounts Standing Board
IFAC – PSC	International Federation of Accountants’ Public Sector Committee
IFMIS	Integrated Financial Management Information Systems
IGR	Institutional and Governance Reviews
IMF	International Monetary Fund
INTOSAI	International Organisation of Supreme Audit Institutions
IPSAS	International Public Sector Accounting Standards
JFA	Joint Financial Agreement
LFA	Logical Framework Approach
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MTBF	Medium-Term Budget Framework
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Financial Framework
NAO	National Audit Office

NDP	National Development Plan/Strategy
NGO	Non-Governmental Organisation
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
PAF	Performance Assessment Framework
PAM	Performance Assessment Matrix
PBA	Programme Based Approach
PEFA PMF	Public Expenditure and Financial Accountability – Performance Measurement Framework
PEFA PMR	Public Expenditure and Financial Accountability – Performance Measurement Report
PERs	Public Expenditure Reviews
PETS	Public Expenditure Tracking Survey
PFM	Public Financial Management
PMUs	Programme Management Units
POM	Department for Policy and Methodology, Sida
PPERs	Participatory PERs
PRBS	Poverty Reduction Budget Support
PRGF	Poverty Reduction and Growth Facility Programme
PRS	Poverty Reduction Strategy
PRSC	Poverty Reduction Support Credit
PSM	Public Service Ministry
QAG	Quality Assurance Group
ROSCs	Reports on the Observance of Standards and Codes
SBS	Sector Budget Support
SC	Steering Committee
SOEs	State-Owned Enterprises
SPG	Sida Procurement Guidelines
SWAp	Sector-Wide Approach
TA	Technical Assistance
TOR	Terms of Reference
UN	United Nations
WB	World Bank
WTO	World Trade Organisation

1 Introduction to PFM in Development Cooperation

1.1 Public Finance Management and Poverty Reduction

Based upon a multidimensional understanding of poverty, Sida's mission is to help create conditions that will enable poor people to improve their quality of life. Consequently, the perspectives of the poor on development and a rights perspective should permeate development cooperation to make it truly poverty focused.¹ To make this concept operational, *Sida at Work* further identifies four principles, which are intended to guide Sida's work: non-discrimination, participation, transparency and accountability.²

The two perspectives lead to a number of issues related to PFM. A sound PFM system is, for instance, a prerequisite for making it possible to effectively channel resources to fulfil a number of human rights, such as access to basic education or health services. The four guiding principles also reveal problems with PFM systems, as their implementation requires the systems to support them. The PFM system is thus crucial in terms of making resources available to implement democratic decisions, as well as for making the democratic system work as such by providing transparency, ensuring accountability and enabling participation.

PFM with a Poverty Focus

Applying a poverty focus to PFM means asking the right questions and giving priority to reforms that overcome impediments to development and poverty reduction:

- Why are medicines not in stock?
- Are resources reaching service units at the local level?
- Can people at the local level check whether resources are used for services?
- Are officials paid on time so that they do not develop coping strategies that are detrimental to the poor?
- Is the budget being implemented in line with a pro-poor development strategy?
- Does the system enable managers to make priorities and manage resources effectively?
- Do reporting mechanisms enable public follow-up and accountability?
- Does the system enable gender analysis by providing enough information?

Economic growth and enabling poor people to participate in economic activity are also essential elements for reducing poverty, and have strong links to PFM. Without proper management of public funds, the macroeconomy will be negatively affected, with adverse effects on the business climate and redistribution of wealth through inflation. Corruption also thrives where PFM is weak and not only limits possibilities for growth, but also directly affects basic human rights.

¹ *Shared Responsibility – Sweden's Policy for Global Development*, Government Bill 2002/03:122.

² Page 16, *Sida at Work – A Guide to Principles, Procedures and Working Methods*, Sida (2005).

In summary, weak PFM means that scarce resources are wasted through poor allocations and inefficient management. This is a serious constraint to poverty reduction that affects both the public and private sector, as well as the effectiveness of development cooperation. Working with PFM is thus not only about ensuring that Swedish resources are used effectively. Primarily, it is about enabling poverty reduction through growth, democratic governance and the effective use of all resources available. Recognition of this provides the rationale for using, and thereby strengthening, national PFM systems in development cooperation³.

Why PFM matters for poverty reduction

- A sound PFM system is a prerequisite for long-term and sustainable poverty reduction, enabling the partner country to manage its own development;
- A PFM system aims at ensuring that budget planning and discipline are compatible with macro-economic stability, resource allocation is in line with poverty reduction strategies, activities are implemented efficiently, and results are followed up;
- It is through the PFM system that national policies are transformed into actions and services are delivered;
- Democratic governance entails democratic control over resources. This is achieved through sound PFM.

1.2 The Role of the State Budget as a Democratic Institution

The centrepiece of public activity in any country is the state budget. It is through the budget process that resources are contested and policies backed up by real financial commitments, leading among other things to the provision of social services. Hence, the budget process is, or ought to be, one of the most important democratic institutions as it is here the real decisions are made. It is also the primary public instrument for redirecting spending in favour of poverty reduction.

However, a sound democratic budget process cannot be achieved without the effective operation of public finance management systems:

- A **sound budget policy** – greatly dependent on the information provided by all the different subsystems of PFM – will make it possible to pursue a macroeconomic policy that aims at economic growth.
- **Democratic governance** is a prerequisite for the citizens to influence the state budget and ensure that the budget has a pro-poor profile. Simultaneously, a state budget that reflects all public resources available, that is transparent and makes it possible to follow-up how resources are actually being used, will contribute to good governance as efficiency increases and possibilities to misuse public resources are controlled.
- Effective PFM systems will strengthen **democratic influence** and **accountability** in the decision-making processes related to the state budget. Transparency is a key element. Well-structured information on the ways in which public resources have been used and the results that have been achieved will significantly strengthen **the accountability process at parliament and public audit institutions.**

³ *Position Paper on Public Financial Management*, Sida (2005).

- **Transparent information** on the government's handling of public resources and what the results have been will strengthen the political debate and bring **energy to the democratic process** in general elections and on other occasions. This will also increase the **legitimacy** of the government's fiscal policy in the eyes of the citizens in both partner and donor countries.

1.3 PFM and the Paris Declaration on Aid Effectiveness

Sweden – together with many other countries and organisations – has signed the *Paris Declaration on Aid Effectiveness*⁴. This obliges Sweden and Sida not only to harmonise procedures with other external actors, but also to **align to partner government procedures and systems**, including the public finance management system.

Utilising PFM systems strengthens them, inter alia by:

- focusing on improving their functionality, thereby overcoming problems that are constraints to development overall and not only in relation to aid-financed activities;
- providing an overview so that all resources can be allocated effectively and are subject to democratic processes and accountability arrangements;
- increasing harmonisation, thereby enabling scarce capacity to focus on the domestic system rather than meeting fragmented accountability demands from development partners.

However, using national systems also implies an obligation to directly support their improvement and functionality. There is a need to be able to orient through the steps of an assessment of the status of the PFM systems, as well as the steps to reform these systems. This is a crucial aspect from a development perspective as well as a fiduciary perspective. Using national systems that are weak and in need of improvement to permit development efforts to succeed involves managing fiduciary risks.

Fiduciary and Developmental Risk

Fiduciary risk is defined as the risk that funds:

- are not used for intended purposes
- are not providing value for money
- are not properly accounted for

Fiduciary risk is closely related to developmental risk, but the latter is both more comprehensive and vital. Developmental risk can be defined as the risk that developmental objectives will not be achieved due to weaknesses in the system.

1.4 The Objectives of Public Finance Management

The objectives of a PFM system are normally defined in terms of:

- Aggregate Fiscal Discipline
- Allocative Efficiency
- Operational Efficiency

⁴ OECD 2005, *Paris Declaration on Aid Effectiveness*.

Aggregate Fiscal Discipline is an overarching objective to ensure that public spending is in line with available resources. Failure to achieve this objective will jeopardise macro-economic stability.

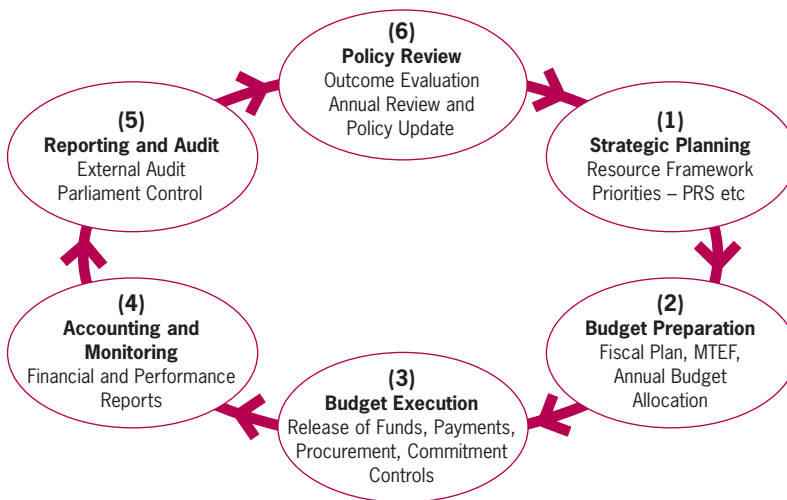
Allocative Efficiency is about allocating resources effectively between different expenditure areas/items in pursuit of the desired development objectives. It entails the strategic shifting of resources from less effective uses to more effective uses.

Operational Efficiency is about making sure that resources are used in such a way that they provide maximum value for money.

1.5 An Overview of the PFM System

This section presents the different subsystems of PFM, how they are related, and some common important conditions in relation to them in developing countries.

Figure 1.1 – The budget process



The PFM subsystems are linked to each other and are used in **annual** and **multi-annual processes**.

The budget process starts with **planning**. Important multi-annual planning instruments in developing countries are the PRS, *Poverty Reduction Strategy*, linked to or, in some cases, even replaced by an NDP, *National Development Plan/Strategy*. Planning in the public sector and for social services is built on special features. Development partners should always align activities to **the government’s planning cycle**. This necessitates very concrete action in relation to Sida’s internal planning process in which Sida, in contact with the partner government, finds out how and when to provide information on ongoing, continued, and new engagements.

Planning for the next period should be based on information on **results** from the previous period. Access to information on results is decisive in a management model where outputs and outcomes remain in focus for decisions on allocations of financial resources for the next period.

Planning not only has to recognise and identify **priorities**. It also needs to be linked to **budgeting**. All political ideas and intentions that derive from the planning process

have to be **costed**. This is being done more and more through a multi-annual fiscal framework, the **MTEF**, Medium Term Expenditure Framework. The MoF has the responsibility for presenting this **overall fiscal framework**; i.e. a projection of the amount of money that can be included in the budget for each year of the MTEF period (normally three–five years). From this, the MoF derives individual fiscal frameworks for different expenditure areas for the same period of time. An expenditure area could represent a sector and, in such cases, the fiscal framework represents the financial resources available for the multi-annual sector plan.

In response to the overall fiscal framework from the MoF, **the sector should present its needs assessment** (based on its visualised insight into absorption capacity in the sector). The intention is that the fiscal framework for the sector presented by the MoF and the needs assessment presented by the sector should be aligned and adjusted to make the fiscal framework for the sector consistent with financial realities. The sector also needs to develop its own MTEF based upon the financial framework.

The sector MTEF should in theory be calculated bottom-up, looking afresh at resource requirements to meet the identified political intentions and needs in the sector. In reality, however, in most countries the MTEF process starts from the previous year's figures and makes marginal adjustments to these – so-called **incremental budgeting**. One reason for this is that priority areas often stay the same throughout the medium term and therefore the budget does not need to change all the way from the bottom up every year.

Other types of calculations could also be included in the MTEF. One could be a gradually higher financial commitment from the government; taking over a larger share of a sector's costs every year from development partners. One important aspect to check in relation to resources decided in the MTEF is that they are equivalent to those included in the sector plan.

It is important that the **MTEF is a rolling process**, i.e. that it is calculated every year for a new MTEF period (normally three or five years) with one new year added annually. In many developing countries National Development Plans or Sector Plans represent a fixed period of time, e.g. 2006–2011, and new calculations are not made until the period has ended. This has the effect that, towards the end of the period, the figures in the plans become increasingly obsolete and unreliable as a planning tool and as a tool for annual resource allocation. In many cases this could represent a conflict between the multi-annual plan for a fixed period of time and the MTEF. Eventually, these planning and budgeting instruments must become consistent.

To **link the annual budget with the medium-term projections in the MTEF**, the annual budget should represent the first year of the MTEF at a more detailed level but with the same financial frame. This is the best way to check that the priorities expressed in the MTEF also are reflected in the annual budget.

After **parliamentary approval** of the annual budget, figures in the budget must be reliable. There are both political and technical limitations to this in many developing countries. Technically, there could be regulations that make it possible to alter expenditure votes approved by parliament through a supplementary budget decision during the budget year. The cabinet and even budget institutions may also have a certain right to reallocate or transfer resources within the budget – although seldom between votes, more often between sub-votes or items.

When the budget has been approved, it should be **executed**. To make it possible to execute the budget, there needs to be a **payment system** that can finance budget expenditure and transfer money to line ministries, government agencies and the lower levels of the administration in accordance with the allocations decided in the budget. Most governments have their own payment system but often utilise private banks for cash transfers. The central bank is normally the host of the government's **treasury system** (i.e. the budget execution and payment system).

As a management tool for budget execution and as a control instrument, there is an **accounting system**, which should register the amounts spent and on what. In many developing countries, the accounts actually represent a **budget follow-up system**, i.e. the registration of expenditure corresponds to the structure presented in the budget. Different classifications in the budget and more advanced accounting systems are gradually being introduced, making it possible to present financial information on resources spent in different and more complex information structures. Information from the accounting system and the payment system has to be checked to certify that individual payments correspond to the expenditure registered in the accounts. This is called **reconciliation** of the accounts.

When the budget resources have been executed and consumed for investments, social services and many other purposes, they should be **audited** to make sure that they have not been misused. Auditing in the countries concerned is almost always financial, i.e. a check on the cash flow in relation to budget allocations. In addition to **financial audit**, there is also often a system of **compliance audit**, which checks the application of existing financial management regulations. **Performance audit** or **value-for-money audit**, which measures efficiency and effectiveness of the utilisation of budget resources, is unusual but on the increase.

Audit can be divided into **internal audit** and **external audit**. The first is a government function, in most cases a direct part of a line ministry, but organised in some countries under the MoF. Often, internal audit is used to “pre-audit” (to check the regularity of transactions in advance), but this is not the role of modern internal audit. Such scrutiny should be handled by the internal control system. Internal audit should work with management to assure the proper functioning of the **internal control system** (i.e. the regulation of how and by whom funds can be handled, financial management routines, etc.) and efficient use of resources. External audit is normally an audit organisation that is independent of the government (a **Supreme Audit Institution**), which, in most cases, submits its reports directly to parliament. The expression “external audit” is also used when development partners initiate audits carried out by private audit firms on activities financed with external funds.

Audit is very dependent on information from other systems “earlier” in the budget process, especially information from the accounting and the payment systems. If information from these systems is poor, it is difficult to carry out meaningful audits.

An important part of PFM systems is **revenue** and revenue collection. It is important that revenue is an integral part of budget projections. Calculations of the amount of money that is available for expenditure are not reliable without advanced revenue projections. Revenue policies and profiles are also important poverty issues due to their impact on income distribution and business opportunities. Government revenue is very sensitive to the development of different parts of the economy (profits in private sector

firms; disposable income in the households, etc) and hence dependent on an effective so-called **macroeconomic projection model** at the MoF.

Read much more on the PFM system and all its features in Appendix 2.

1.6 Actors in the PFM System

There are normally a number of important actors that participate in the process of allocation and consumption of public financial resources:

1.6.1 Under the government:

- The *Ministry of Finance* (MoF) represents the centre of PFM-related processes and is normally responsible for the economic policy and budget policy. The MoF is the coordinator of the budget process including budget management, accounting and reporting systems, treasury functions (budget execution and payment system) and debt management. In government ministries there are also internal audit functions under the MoF or under each ministry where they operate.
- Sometimes there also is a ministry of planning or a government organisation with corresponding responsibility for the planning process. In some cases, planning and finance have been merged into one ministry, usually regarded as the best solution considering the close relationship between planning and budgeting.
- The MoF collaborates in the budget process with line ministries. They are involved in budget preparation and also have the responsibility for the execution of the budget, directly or through their local government representation in regions, provinces, districts and communes/municipalities.
- Budget execution can also be carried out through independent government agencies. A common autonomous government agency at the central level is the revenue collection agency. In most cases you will find several other autonomous institutions under the government. In addition, the government sector almost always includes state-owned enterprises (SOEs) or parastatals as they are called in Anglophone Africa. In many countries you will also find state-owned banks. Both the SOEs and the banks may be heavily subsidised, causing financial problems for the government and the MoF.
- In many countries there is a public service ministry or a corresponding body responsible for important areas linked to the budget process, such as public sector reform initiatives. The PSM is also normally responsible for organisation, staffing, the personnel policy and policy for civil servant *salaries*, and registration of these in the payroll system.
- Other important government actors in the budget process are the Offices of the President and of the Prime Minister, which often have a substantial influence on the profile of the budget.
- There are often also local authorities that administer public resources which have been assigned or transferred to them. Read more about fiscal decentralisation in chapter 8.

1.6.2 Under Parliament

- In many countries parliamentary decisions on the government's budget proposal and on other public finance issues are prepared and discussed in the Standing Committee (or Commission) on the Budget and Public Finances, which also is the dialogue partner with the MoF during the different phases of the budget process.
- Several countries, especially those with a British colonial background, have a Public Accounts Committee at parliament, ultimately responsible for checking the financial and performance accountability of the government.
- In most countries, the Supreme Audit Institute submits its reports to parliament. The independence of the Supreme Audit Institute (Auditor General, Cour de Comptes) is a critical issue.
- The central bank is another important actor in the government's budget process. Sometimes the bank regularly produces macroeconomic forecasts. The bank is usually the host for the cash flow of the government's treasury system and manages government funds on a number of bank accounts, some of them linked to a single treasury account system. In some countries the central bank is independent. In others it is subordinate to parliament.

1.6.3 Other Actors

Many other actors influence or participate actively in the government's budget process. One of them is the media that could influence many individual decisions on budget allocations. Other important parties are different target groups for budget resources, especially at the local level, civil society, the private sector and NGOs. Budget issues linked to processes at the local level are further presented in chapter 8.

2 PFM and the Cooperation Strategy

This chapter provides an operational guide to the task set out by the Swedish government in the Guidelines for Cooperation Strategies, which require an analysis of PFM. It defines the task, explains what the main issues are and provides the primary tools. It also provides a summary of the handbook as it defines the general approach to working with PFM in development cooperation.

In this chapter you can read about;

- **What to do in relation to PFM in the cooperation strategy process**
- **The broad framework of what is included in the budget analysis**
- **The approach to assessment of PFM systems and managing risks**
- **The importance of the capacity issues linked to PFM assessment and PFM reform**
- **The composition of a credible PFM reform programme**
- **Corruption and PFM**
- **Alignment as a part of the Paris Declaration and its links to PFM reform**

All of these issues except the section on PFM and the cooperation strategy are presented in more depth in the following chapters of the handbook.

2.1 Introduction

The Swedish **Guidelines for Cooperation Strategies** list a number of assessment criteria for long-term cooperation and require, inter alia, a special analysis of PFM. Based on this and other assessments, dialogue issues should be identified together with cooperation areas and possibilities of alignment, and requisite resources estimated, including the share to be allocated to programme support. Possibilities to extend budget support shall be examined and are dependent upon the status of the PFM system. It is also through the strategy that Sida is given the mandate to enter into formal budget support decisions. In brief, an assessment of PFM is required for all long-term cooperation strategies.⁵

The PFM assessment is an important input in determining **Sida's position on strategic issues** and should also be a foundation on which subsequent sector assessments can be based. It should feed into a broader assessment of whether the PRS is feasible to implement, and the areas that should receive support or be in focus in the dialogue. It also gives information on absorption capacity and the fiduciary risks⁶ involved including corruption – crucial variables in determining the scope of cooperation and appropriate aid modalities. It further identifies constraints to development as well as means to overcome them, thereby enabling risks to be managed and opportunities to be grasped. In this way it is fundamental for the assessment of the possibilities of alignment with national policies and systems.

This part of the handbook sets out to explain how to make this assessment by identifying what needs to be looked at, highlighting critical issues, introducing tools, and giving practical advice. It is recognised that, while **Sida must be able** to identify issues, understand the problems and how to address them, take positions and be a competent dialogue partner, the PFM assessment as such may require external expertise. Existing material/diagnostic studies should be used as the basis for the assessment, which should preferably be a joint undertaking together with other partners. All the same, **Sida must draw its own conclusions** on the basis of the material and document them.

2.2 What To Do

In the cooperation strategy process, there are **two basic areas** that have to be assessed:

- The first is to check that the actual allocation of resources is in line with political decisions, within resource constraints, and shows a commitment to reduce poverty. This check is made through the **budget analysis**.
- The second is to check the **technical status and capacity of the PFM system** in order to identify weaknesses, assess how they affect the possibilities of implementing the budget and exercising democratic governance, and assess how weaknesses are addressed and appropriate ways of managing risks.

Below, you will find more material on how to make the assessment and, in chapter 5, more about PFM diagnostic tools and different issues that you need to be aware of when assessing PFM.

⁵ *Guidelines for Cooperation Strategies*, Ministry for Foreign Affairs, Sweden (2005).

⁶ Fiduciary risk: The risk that funds are not used for intended purposes, are not providing value for money and are not properly accounted for.

2.2.1 The General Approach and Requirements

The point of departure is that **weak PFM is a serious development problem**. It is not just a fiduciary concern of development partners. In practice, this means that we need to find out how we can best relate to the weak environments that are constraints to poverty reduction and, jointly with partners, address the constraints by supporting the improvement of PFM systems.

Hence, the task is not primarily to judge whether the systems are good enough or meet predefined criteria, but whether our support (e.g. to a sector programme or PRS) can effectively contribute to poverty reduction. Obviously, the answer to that question can be negative if the PFM systems are weak, but that conclusion should not be drawn on account of the identified weakness per se, but from limited prospects of addressing these development problems effectively.

The **Cooperation Strategy Guidelines state that an assessment should be carried out** in order to determine the actual status and practical use of the PFM system, whether there is a positive trend of improvement and capacity to sustain the trend, and whether reforms underway are credible and address identified weaknesses and capacity problems. The risk of corruption should be given a prominent place in the assessment and the government's attitude to corruption and readiness to act against it should be explicitly and coherently assessed. Risks and anticipated effects of reforms, as well as possibilities of managing identified concerns through appropriate follow-up via indicators or additional safeguards, need to be included. Anticipated positive effects of aligning with the system, and the adverse effects that being "off-system" may have, need to be considered. If at all possible, this should be done jointly with other actors and make use of existing material. However, conclusions on the basis of the assessment must be drawn individually by Sida and documented.⁷

The depth of the assessment will depend on the circumstances and may also be something that is developed over time. Most likely bits and pieces are added up well before the strategy process commences in regular analytical work. However, **the bottom line** is that Sida should have enough knowledge to be able to point out development constraints and fiduciary risks, assess if these are being dealt with, and be able to identify what this means in strategic terms for development cooperation. The level of ambition in this work may vary depending on the country context and nature of cooperation, but rigour is called for considering the central importance of PFM for overall development and aid effectiveness.

A higher level of ambition when assessing PFM may be called for if:

- Swedish aid is substantial as a share of the state budget or sector budgets
- Budget support is contemplated but has not previously been given
- Public finance management is identified as possibly a major constraint
- There is insufficient knowledge of the poverty orientation of the budget
- Corruption is a significant problem and related to PFM
- Alignment with national systems is desired

⁷ P. 22, 23–24, 48, *Guidelines for Cooperation Strategies*, Ministry for Foreign Affairs, Sweden (2005).

Table 2.1 below presents an overview of the main PFM issues, which need to be handled in the programme of cooperation with a partner country, and hence **need to be assessed in order to formulate a cooperation strategy**. Further guidance on how to assess each of these issues is then discussed in more detail in subsequent parts of the chapter.

Table 2.1

Content	Issues
1 Budget/MTEF analysis	Is the budget/MTEF geared towards poverty reduction and in line with the PRS and the macroeconomic framework? What are the main issues?
2 PFM system and capacity analysis	Is the system capable of delivering services and enabling democratic governance? What are the main issues/risks and how are they/can they be addressed? Has there been a trend towards improved PFM? Is there a credible reform programme in place or under development?
3 Risk of corruption	Where are the largest corruption risks, how are they addressed by the government? How can we handle them?
4 Positive development effects of alignment	What evidence/prospect is there of deriving positive effects from using the national systems? What evidence/likelihood is there of negative effects from not aligning with national systems?
5 Conclusions for the Cooperation Strategy	<p>Draw strategic conclusions from a PFM point of view:</p> <ul style="list-style-type: none"> • Overall risk (high, medium, low) • PRS – Is it feasible to implement it given the capacity of the systems and allocation of resources? Are there issues that need to be addressed through dialogue, perhaps in need of support or close follow-up via indicators? • Budget/MTEF – Is its composition balanced and in line with the PRS? What dialogue issues do you identify? • Alignment – What are the general prospects of using government systems? Can all sub-systems be used including the procurement system or just some, taking into consideration ongoing efforts to improve them and possibilities of managing risks? • Budget Support – Would general budget support be feasible, if not what needs to be addressed to enable budget support as an aid modality? • Sector Programmes – Could they be financed through budget support? Are they constrained by PFM issues? • Capacity Development – Are there specific issues that have been identified that development cooperation could address or that would enhance the effectiveness of support to other areas? • Volume of aid – Given the budget analysis and the capacity of the PFM system including risks, is there a need for more aid and could increased funds be managed well? • Areas of intervention – What does the assessment point to? What constraints and sectors could be addressed by Swedish development co-operation?

2.3 Budget Analysis

Resources are scarce and needs are great. Hence, a policy area or sector plan is not always backed up by budget resources to implement it as in the competition for resources in the budget process, or later when the budget is intended to be implemented, another policy area supported by more powerful actors may get the upper hand. Poor planning and budgeting may also result in overambitious plans that cannot be

funded by available resources. And lack of information results in poor targeting with the effect that resources are not allocated effectively. Looking into this is what the **budget analysis is about** – aiming at **whether the budget is geared towards poverty reduction and is feasible given resource constraints**.

There is a distinction between budget analysis and macroeconomic analysis. This handbook will not deal with the latter. Hence, issues of whether the fiscal and monetary policy is conducive to growth will not be treated here. Furthermore, it is assumed that an analysis of economic policy would look into the share of the public sector in the economy; whether the aggregate level of spending is consistent with the macroeconomic framework, and the budget deficit is sustainable.⁸

There are a number of **tools for budget analysis** and it is very likely that there are IMF and WB Reports, Public Expenditure Reviews, Expenditure Tracking Surveys and Budget Execution Reports from which we can extract the required information and draw conclusions. The **comprehensiveness of the budget** is crucial. Be as aware as possible of what is not in the budget or is hidden, such as liabilities. It is recommended that you read more about the different issues, instruments and what to think of when analysing budget documents in chapter 5.

In principle, the **budget analysis can be divided into two blocks**: The first is to check if resources are allocated in line with policies (PRS and sector plans) and show a commitment to poverty reduction, and the second is to check if the budget composition allows for efficient implementation of the policies.

2.3.1 Budget Policy

- Does the budget/MTEF's allocation pattern, including past outcomes of the budget, show a general commitment to poverty reduction?⁹
- To what degree are the priorities and expenditure areas identified in the PRS and other planning instruments such as sector strategies reflected in the MTEF and the state budget? Are these documents consistent? Where do you find major deviations?
- What are the major shifts in the budget/MTEF? Are these consistent with the priorities in the PRS?
- Does the MTEF/budget discuss priorities and reallocate resources in favour of them, or is the budget/MTEF incremental – merely increasing allocations across the board in line with inflation or increased revenues.
- Are results of expenditure programmes or analytical findings such as gender analysis taken into consideration when discussing priorities? Or are reallocations only based on addressing new needs/priorities? Can you, for instance, see any impact of the annual review of the PRS on the budget?
- What are the true priorities? Is the budget outcome different from the budget allocations approved by parliament? Is there a pattern of overspending of certain policy

⁸ There are a number of strong links between the planning and budget processes and macroeconomic analysis. One of them is the so-called macro model which defines the resource envelope for the public sector and presents opportunities to calculate different financial consequences for the public sector of i) different macroeconomic scenarios and ii) interventions in legislation determining the volume of public expenditure or revenue.

⁹ This question is indeed as important as it is dangerous. We have to recognise that we do not know a priori what a pro-poor expenditure pattern looks like and that it is context-specific. However, it is important to know how resources are allocated between expenditure areas, and to question allocations that seem to be in contradiction with a commitment to poverty reduction, e.g. if military spending increases at the expense of social services.

areas/ministries and underspending of others in relation to the budget? What conclusions can be drawn? Is this caused by absorption problems or internal power structures?

- Are there spatial/geographical imbalances in allocation patterns that seem odd in light of the PRS?

2.3.2 Budget Composition

- What is the level of discretion in the budget – (i.e. the amount of funds available for allocations once “inescapable” expenditures such as debt repayments and pensions are subtracted)? What implications arise – for example limited ability to redirect financing in favour of more pro-poor areas in the short-run, to finance new investments, or to finance the recurrent costs of operating and maintaining investments? Does this call for structural measures or more aid? Is the budget vulnerable as a consequence of a high level of non-discretion?
- What is the balance between capital expenditures and recurrent expenditures? Is it reasonable and in line with the PRS? Is it feasible, i.e. can the investments be made given capacity constraints and can the recurrent costs of operating new investments be met? Looking at the composition of revenue – are recurrent expenditures financed by predictable and continuous sources of revenue or by loans or temporary sources? What are the implications in terms of vulnerability and sustainability (aid dependency)? On what side is the overall constraint (recurrent or capital)?
- What is the composition of the budget in terms of cost items (salaries, operations, grants etc)? Are salaries crowding out operational costs? Do the PRS/Millennium Development Goals require a cost mix (increased salary bill due to employment of nurses and teachers) that cannot be supported due to budget constraints (such as a cap on salaries in the IMF programme)? Does this point to a need for a civil service reform, more aid, or increased tax efforts? What are the implications for current sector programmes in the social sectors?
- What is the balance in the allocation between central and local level? Is a disproportional part spent on administration at central level at the expense of local service provision?
- What is the balance between central institutions? Are line ministries given the authority to manage all resources in the sectors, or does the MoF administer resources to be transferred to local levels, investment credits in sectors, etc? Is there a large amount for contingencies at the discretion of the MoF?

In the assessment there may be difficulties in responding to all the questions above due to limited data, an absence of reports analysing the budget (e.g. PER), or inadequate presentation of the budget. However, this is in itself a significant finding, pointing to issues that may be addressed in development cooperation. For instance, if no comprehensive budget analysis has been made, there may be need to support such work to increase democratic control and enhance the poverty focus of public spending.

2.4 The PFM System Assessment

The capability of the PFM system to execute the state budget while maintaining control must be assessed. The focus of the assessment should be on **fiduciary and developmental risks** in utilising the system, and how PFM reform could impact on performance. Ultimately, the assessment should be able to answer to the question: How effectively and efficiently can the PFM system deliver intended (poverty-related) public services and secure democratic governance?

In this section we outline the basic tools for the task. Read more about PFM system diagnoses, capacity assessment and PFM reform in chapters 5 and 6.

2.4.1 PEFA Performance Measurement Report

The newly introduced and internationally recognised diagnostic tool for PFM system assessment is *the PEFA PMF* (Public Expenditure and Financial Accountability – Performance Measurement Framework).¹⁰ The PEFA PMF identifies **critical issues of performance in the PFM systems** in six different areas:

- Credibility of the budget – whether it is realistic and possible to implement
- Whether the budget is comprehensive and transparent
- Whether the budget process enables policy based budgeting
- Predictability and control in budget execution
- Adequate accounting, recording and reporting
- Arrangements for scrutiny and audit

As a first step the PEFA Performance Measurement Report (or corresponding diagnosis if there is still no PEFA assessment available) should be used to identify main weaknesses in the PFM system. However, **the PEFA tool only looks at the system's status**. It does not give information about the underlying causes or the issues that matter most from a developmental or fiduciary perspective. Furthermore, the PEFA tool does not present an action plan on how to address weaknesses. This is intentional as to do this there is a need to make priorities and consider many other aspects such as capacity constraints. In many cases, these kinds of measures have already been identified in PFM reform programmes. PEFA PMR has thus several limitations, which it is important to be aware of – read more about them in chapter 5.

2.4.2 The PFM Risk Management Matrix – a Tool for Integrated Analysis

In its *How to Note on Managing Fiduciary Risk when providing Budget Support*, DFID has developed a simple **matrix that is a powerful instrument for assessing the situation on the basis of existing diagnoses, appraisals of reform and capacity studies**.¹¹

By going through all core dimensions of the PFM system, noting their status and the risk associated with each of them, one is able to see whether reforms or other measures are addressing the issues. By doing so, a comprehensive picture of the main issues and how they are addressed is obtained, which enables us to draw strategic conclusions and identify risk management measures. An example is given in the table below.

¹⁰ *Public Financial Management Performance Measurement Framework*, PEFA Secretariat, World Bank (2005).

¹¹ *Managing Fiduciary Risk when providing Poverty Reduction Budget Support, How to Note*, DFID (2005).

It is mandatory for DFID to carry out a Fiduciary Risk Assessment (FRA) based on this approach when providing budget support. Hence, in many cases the work has already been done or could be **done jointly** with DFID and, of course, other partners. The matrix suggested by DFID is still being refined with the intention of making the dimensions identified in the note compatible with PEFA. It is recommended that the matrix is used as a tool for an integrated analysis of developmental and fiduciary risk mitigation.

Table 2.2

PEFA Indicator	Score (see PEFA guidelines)	Risk Rating	Trend	Overall Assessment – specifying key developmental and fiduciary risk(s) including risk management/mitigation. Take into account related reforms, capacity concerns, progress to date and expected progress, risk of corruption.
PI-1 Aggregated expenditure out-turn compared to original budget (i.e. budget variance)	A	Medium	Negative	
PI-2 Composition of expenditure out-turn compared to original budget	B	High	Flat	
...				
PI-6 Comprehensiveness of information included in the budget documentation	A	Low	Positive	
...				
PI-10 Public access to key fiscal information	D	High	Positive	
...				
PI-19 Competition, value for money and controls in procurement	C	High	Flat	
....				
PI- 23 Availability of information on resources received by service delivery units	C	High	Positive	
....				
PI-28 Legislative scrutiny of external audit reports	B	Medium	Positive	

The matrix would, in principle, use **two main sources of information**: Firstly, assessments of PFM status using the PEFA instrument or/and other diagnoses, and secondly, information about ongoing reforms, including capacity development efforts. This information is captured, to some extent, in the PEFA PMR, which provides a summary of

ongoing reforms. However, in most cases it needs to be complemented by PFM reform documents and appraisals.

Analytical work is required to assess whether reform measures suggested in a particular risk area are likely to suffice. Moreover, the PEFA PMR does not assess risk, it merely indicates areas where systems are below international standards. Hence, an assessment is required of **what the risks are great in relation to: development objectives (poverty and democratic governance), alignment with the system (budget support), opportunities for corruption, etc.** Normally, this work would require assistance from PFM experts.

It is important to sort out what the major constraints are as it is likely that improvements will be called for in many areas. Nevertheless, it is important to **single out the most strategic risks by constantly focusing on what matters most for the poor** by applying the two perspectives (perspectives of the poor on development and the rights perspective). Sorting out what the most important constraints are requires a good understanding of the **actual situation in the partner country**, for instance regarding service delivery in sectors.

The constraints will differ depending on circumstances in the country concerned. In one country, enhancing democratic influence over the budget may be the number one priority, thus leading to a focus on improving the budget presentation and process, transparency of transactions, and strengthening supervisory bodies and the ability of civil society to participate in the budget process. In another country, the most critical issue may be to ensure that funds indeed reach service units, thus leading to a focus on budget execution.

A word of warning on managing risk is required. Safeguards, indicators and conditionalities must not be imposed, or proposed, without a comprehensive understanding of how they fit in with government priorities and reforms. In the past, uncoordinated safeguards and conditions have contributed to a short-term focus, fragmented reforms and overloading of existing capacity. Sequencing of reforms is difficult and it may not be feasible to start with the problems one would like to address or they will take years to overcome. **The preferred solution is thus to engage in PFM reform** and support it to address the concerns comprehensively in a sequenced and prioritised manner. Read more about PFM reform in chapter 5.

2.4.3 The Capacity Issue

There is one important aspect that is overlooked more often than not when PFM systems are diagnosed – **the capacity issue**. PEFA PMR, and other diagnostic tools, focus on the technical performance of the system. As these diagnoses provide the foundation for reform, this may lead to a reform that focuses on technical solutions without full knowledge of the capacity constraints that partly cause the problems at the institutional or organisational level. Moreover, as capacity assessments are seldom undertaken, **there is a risk that reforms are designed without full knowledge of whether there are human resources and capacity to implement them**. Hence, it is often necessary to support a study of capacity together with government and partners before reforms are suggested on the basis of diagnostic tools. Read more about this in chapter 5 and 6.

2.4.4 The Relative Trend

From the analyses made using the matrix, it should be possible to judge whether PFM is improving or not – in particular if there have been subsequent PEFA assessments or HIPC AAPs.¹² Emphasis should be put on **real improvements in terms of PFM outcomes**, not merely that reform activities have been implemented (e.g. improved timeliness of budget releases rather than introduction of a computerised financial management system).

In assessing the relative trend, the **likelihood of improvements** also needs to be taken into account – this calls for an assessment of ongoing and planned reforms. From the matrix exercise discussed above, we would have acquired information on whether specific reform initiatives address identified weaknesses and seem credible at the technical level, but this needs to be complemented by an assessment of the overall credibility of the reforms.

Assessing credibility is not an easy task as **PFM reforms are set in a political economy** where power relations are important determinants. The most critical questions therefore relate to ownership at various levels and the capacity to undertake reforms.

Normally, there would be PFM reform appraisals, reviews and other documents that treat these aspects. The set of questions below, used by DFID, may serve as a guide when drawing conclusions on the basis of such documents.¹³ A credible programme should:

- be **government led** – enabling full political ownership and leading to effective harmonisation of donor interventions
- be **realistic and achievable** – based primarily on available local capacity and set within an appropriate time frame
- integrate individual measures of improvement with a **comprehensive framework** which is effectively **sequenced and prioritised**
- be **relevant and sustainable** – adopted to the specific country context, targeted to meet key developmental and fiduciary risks and avoiding over-reliance on external technical assistance
- focus on **developing local capacity** – capacity development strategies should be a central component of the programme, considered from the outset of reform design
- build **demand for change** – promoting a sustainable track record of improvement based on previous successes, to develop a momentum and impetus for change
- include specific **performance indicators** – with effective monitoring and evaluation against relevant targets and milestones.

Most likely the situation will not be a perfect one. What are the weakest spots? What are the strengths? Can the weaknesses be addressed somehow, enabling us to jointly overcome these constraints to successful reform? Can the strengths be built upon, for example to broaden ownership? What, if anything, does this imply for our cooperation and choice of instruments?

Read more about PFM reform in chapter 6 and 7. Consult also DFID's *How to Note – Managing Fiduciary Risk* when providing *Poverty Reduction Budget Support*.

¹² HIPC (Heavily Indebted Poor Countries) *Assessment and Action Plan* – a diagnostic tool comprising 15 indicators of sound PFM.

¹³ *Managing Fiduciary Risk when providing Poverty Reduction Budget Support, How to Note*, DFID (2005).

2.5 Corruption

The Cooperation Strategy Guidelines call for an **assessment of corruption** including the partner government's attitude towards it and the actions it has taken to fight it. Such an assessment touches upon many issues apart from PFM, as the causes of corruption are manifold. These guidelines only address assessments of the risk of corruption arising from weak PFM systems – not the reasons to why people may take advantage of opportunities for corruption. Read more about PFM and corruption in chapter 7. As regards general anti-corruption work, reference is made to Sida's *Anti-Corruption Manual*.¹⁴

The assessment of risks discussed above will give a good idea of the corruption risks arising from weak PFM. Where **fiduciary risk is high – opportunities for corruption exist**. In assessing corruption (and fiduciary risk), the concept of materiality¹⁵ is important. The risk may be high but the volume of funds exposed to it may be limited. In that case it may not be the primary concern. We know where the large sums of funds are from the budget analysis. By comparing the budget with the risks in the PFM system assessment we get a clearer picture. For instance, if the payroll system is weak and salary payments account for 50% of the budget, this is an area of interest. The **budget analysis also tells us if expenditure patterns are skewed** – something that may point to corruption (as well as discrimination): for instance, if more resources are allocated to the ruling party's constituencies or new capital-intensive investments are favoured over maintenance.

It is important to gather **information from several sources** as the PFM diagnosis focuses on the system, not on actual cases of corruption. General knowledge of where corruption occurs, for example from Transparency International, also gives clues as to those parts of the systems that are most vulnerable. Public Expenditure Tracking Surveys and User Surveys are other important instruments that highlight areas of concern, in addition to audits.

PFM reform is a crucial part of an anti-corruption strategy and, if there is a credible reform programme and performance is improving, this should be acknowledged on the positive side. A weak PFM system not only creates an immediate risk of theft of public resources, it also indirectly affects corruptive behaviour. For instance, if salaries cannot be paid in time, people may take advantage of opportunities to sustain their livelihoods. Hence, an effective PFM system both secures control of public resources by being transparent, open, and having proper accountability arrangements; and promotes effective handling of funds, thereby indirectly reducing the likelihood of engagement in corruption.

2.6 Alignment

In line with the Paris Declaration, **Sida shall align to the maximum extent possible with national systems**. Using the systems is a powerful means to strengthen them. But how do you assess these positive effects and make them tangible so that the risk of using the systems can be weighed against the positive effects of using them? There is no final answer to this question but some suggestions are provided below while further work is ongoing.

¹⁴ *Manual – Sida's Anticorruption Regulation*, Sida (2004).

¹⁵ Materiality equals the significance of the weakness, i.e. if there is a low risk but substantial funds are exposed, materiality would be high.

Let us start with some **arguments in favour of alignment**:

- Harmonisation requires harmonising around something: the only common denominator as regards financial management is the national system.
- Failure to align adds to transaction costs and drains the capacity of the system as scarce resources are deployed to work on different systems. The focus of dialogue and conditionality is diverted to development partner procedures rather than to the functioning of the national system, and resources are made available to manage separate development partner systems, not the national system
- A focus on managing aid well, which is only a portion of the public resources, means that most of the public resources may be subject to wasteful spending and corruption. Aid-financed activities are heavily dependent upon domestic activities and, in such an environment, risk being islands of success in an ocean of failure. Actual results for the poor will suffer.
- Democratic institutions such as the budget process and domestic accountability arrangements can only work when all resources are known and subject to them. You cannot allocate resources effectively if you do not know whether some areas are already covered (e.g. schools already under construction through off-budget funding), and democratic control is undermined if allocations are not subject to it.
- Incentives are weak for improving the systems when by-pass solutions allow business to continue as usual – resulting in a vicious circle. For example, if a sector does not receive funds in accordance with the budget, and resources in the sector are not trickling down to service delivery, development partners may have conditions in respect of this while directly financing operations at district level. However, often the conditions stipulated by the development partners are ineffective because incentives do not work in favour of addressing the identified PFM problems. Service provision units may prefer direct financing from development partners as these resources are more predictable, and at the sector top-level it becomes more important to secure development partner funding rather than working to rectify the problems related to the internal PFM system. In turn, the MoF may perceive the sector as taken care of by the development partners, and thus, when cash constraints arise, the sector is not given priority. Development partners are, in turn, reluctant to enforce the stipulated conditions related to the national PFM system, as failure to meet them merely confirms the need for a by-pass solution to secure service delivery.

So what can you make out of this? Is it possible to assess the positive effects of aligning or not in a given country? We suggest that the **following elements be considered** in drawing conclusions:

- How much aid is off-budget?
- To what extent are separate financial management procedures deployed?
- To what degree are human resources allocated to work on the management of development partner procedures? Is this draining already scarce capacity?
- Does the dialogue really focus on the performance of the national system or does it focus more on making sure that development partners' funds are correctly handled? What is the proportion of attention/resources deployed for the former in relation to the latter?

- Is there any evidence or are there any indications of vicious circles? Do incentives really work in favour of improving the systems or not?

This would give a rough guide to whether the benefits of alignment are large, which could be made more specific when discussing the use of PFM subsystems. For instance, if the procurement system is weak, consider the proportion of the procurement staff that is managing procurements by using development partner procedures and the potential strengthening that could come about from redirecting those resources to improving the management of national procurements.

3 PFM and General Budget Support for Poverty Reduction

This chapter highlights PFM issues to consider when providing General Budget Support for Poverty Reduction (GBS). It builds upon the PFM assessment discussed in chapter 2 and discusses how the PFM issues identified in the cooperation strategy process can be handled in the in-depth preparation and subsequent management of GBS for Poverty Reduction.

In chapter you can read about:

- **Budget support definitions**
- **How the PFM assessment relates to GBS**
- **The Performance Assessment Framework of GBS and PFM**
- **What to think of when designing GBS from a PFM perspective**

3.1 Budget Support Definitions

In the Swedish Guidelines for Cooperation Strategies, *General Budget Support* (GBS) is defined as “a non-earmarked financial contribution to the recipient country’s national budget, aimed at promoting implementation of its PRS”, whereas *Sector Budget Support* (SBS) is defined as “a non-earmarked financial contribution to the national budget but where assessment, dialogue, conditions and evaluations focus on a particular sector”.

It is important to note that the **financing modality is budget support in both cases** and that “General” defines the purpose, i.e. to support the PRS. Thus, in financial terms, there is no difference between Sector Budget Support and General Budget Support. The difference lies in the scope of the programme that these two aid modalities contribute to and this, in turn, has consequences for the institutional arrangements relating to the two forms of support (aid modalities).

Considerable confusion arises in this matter since any contribution to areas covered by the PRS supports its implementation regardless of what it is called. However, GBS focuses on the overall implementation and monitoring of the PRS (including its operationalisation through the state budget). Its scope is normally operationalised through a jointly agreed *Performance Assessment Framework (PAF)*, which focuses on key reforms, cross-cutting issues and development results (e.g. the millennium goals). In essence, this is the programme which GBS contributes to, and the PAF may or may not include a specific sector focus (e.g. health). Hence, when appraising GBS, one needs to focus not only on the prerequisites for GBS as defined in the Cooperation Strategy Guidelines but also on the GBS programme, i.e. the PAF, to see whether it fulfils the assessment criteria defined in *Sida at Work*.

3.2 Moving from the PFM Assessment in the Strategy Process

Based on the PFM assessment made in the cooperation strategy process (described in chapter 2 above), there should be a good understanding of the main PFM risk areas/development constraints, including how they are currently being addressed. It is likely that this assessment will have identified some issues that should be checked in the in-depth preparation phase and subsequently monitored during implementation. In the discussion on the content of the PAF, these PFM issues should be given consideration to allow the **GBS to become a means to address identified development problems**. For instance, if procurement is weak and assessed as being a severe development constraint or fiduciary risk, the programme (PAF) and the dialogue should address this issue, for example through an indicator/benchmark on procurement audits. By designing GBS in such a way, its effectiveness will be demonstrated in a tangible manner, which allows for better decision-making on its pros and cons in specific cases, as well as a clear link to monitorable results.

However, the PAF should be derived from the **government’s own plans and objectives** as defined in the PRS and its monitoring framework, and be mutually agreed with all partners. PFM is normally covered in the PRS, but often in terms of desirable reforms rather than clear priorities and tangible outcomes that can be monitored. This can be overcome by **aligning with the national control/monitoring system or ongoing PFM reform**. For instance, one crucial aspect to enable budget support to work is that funds reach budget holders, allowing them to provide services in time.

Monitoring that the budget is executed as intended places no extra burden on the administration as this is one of its main tasks stipulated in the legislation. Choosing indicators that are based upon the national control system also leaves **policy space** and strengthens **domestic accountability**. Hence, PAF indicators may strengthen the system through alignment with the national control system, which also enhances the management framework of the state budget. An example of this is Zambia's Poverty Reduction Budget Support.

Zambia's Poverty Reduction Budget Support

Zambia's PFM system was generally considered weak but improving when GBS started in 2002. The main concerns were the poor credibility of the budget and weak accounts. The PRBS addressed this developmental problem by clearly focusing on these issues through a range of indicators on budget execution which, at the same time, supported cash-flow planning, bank reconciliation and accounting. Indicators used were, inter alia:

- % released of the domestic discretionary budget of key ministries
- % released of the domestic discretionary budget to districts (health)
- % of expenditures reconciled to monthly releases and adjusted for changes in bank balances as a share of reported releases to key ministries

Recognising that timeliness was important, monitoring of the execution indicators was also done in-year. Moreover, the Office of the Auditor General's budget was a concern since only a portion of its budget was normally released by the Ministry of Finance. A specific indicator on releases to the OAG was thus also added.

The last review of the PRBS, made in June 2006, shows remarkable improvements in all PFM indicators over the time period.

Source: Assessment of the PFM Indicators of the 6th Variable Tranche, EC Delegation Zambia, July 2006.

The PAF may also include **monitoring of reform efforts**, for example specifying that a new financial bill should be passed or that an IFMIS system should be introduced. Care should be taken to ensure that such benchmarks/milestones support ongoing reforms, which build upon what is there, and seek to address basic functionality and sector needs rather than moving ahead with advanced practices. PFM reform takes time and has, in the past, often been driven by conditions which, in many cases, have had adverse effects on ownership, sequencing and prioritisation. From the discussion on the PEFA instrument in chapter 2 and 4, it follows that linking conditionality to achieving PEFA benchmarks as such would be unsuitable for this reason.

Below follows a list of **PFM aspects to consider** in PAF design and negotiations:

- Do the PFM issues in the PAF focus on the major constraints to poverty reduction as identified through the PFM assessment (described in chapter 2)?
- Do the PAF indicators/conditions focus on PFM outcomes which are defined by the national system and legislation, such as adherence to timely reporting of expenditures or execution of the budget?
- Are PFM reform issues in the PAF matrix consistent with the PFM reform programme and sequenced and prioritised accordingly?

- Are the needs of the sectors considered in terms of PFM outcomes and reforms?
- Avoid micro managing the budget through input indicators, such as agreements on the share of the budget going to specific expenditure areas, as this will undermine the budget process. Support, instead, institutionalised expenditure reviews, expenditure tracking surveys and analytical work which will feed into the budget process. Support transparency and participation in the budget process by civil society and parliament to enhance the democratic process around analytical findings.
- Normally, budget execution is a critical aspect clearly linked to service delivery. Is there a clear focus on timeliness of releases and payments in-year, and are these also monitored at lower/sector levels?
- It is important that PFM issues introduced in the PAF matrix represent a realistic level of ambition that encourages but does not paralyse PFM reform. What could reasonably be achieved during a specific period of time?
- Also, PFM issues included in the PAF matrix need legitimacy. This means that parliamentary actors also need to be included in the dialogue on the PAF matrix. This is also important from the point of view that many PFM issues do not correspond to the mandate of the government, but parliament (e.g. external audit).
- Consider how the PAF indicators can support domestic accountability by monitoring adherence to the budget and legislation rather than introducing external accountability demands.
- Involve civil society in monitoring activities, and complement budget support with support to supervisory bodies and civil society.

4 PFM in the “sector” and Sector Programme Support

The purpose of this chapter is to describe how PFM issues affect decisions on contribution management. The main focus is on sector programme support. It discusses ways of increasing effectiveness by taking into account PFM issues and alignment with national systems.

In this chapter you can read about:

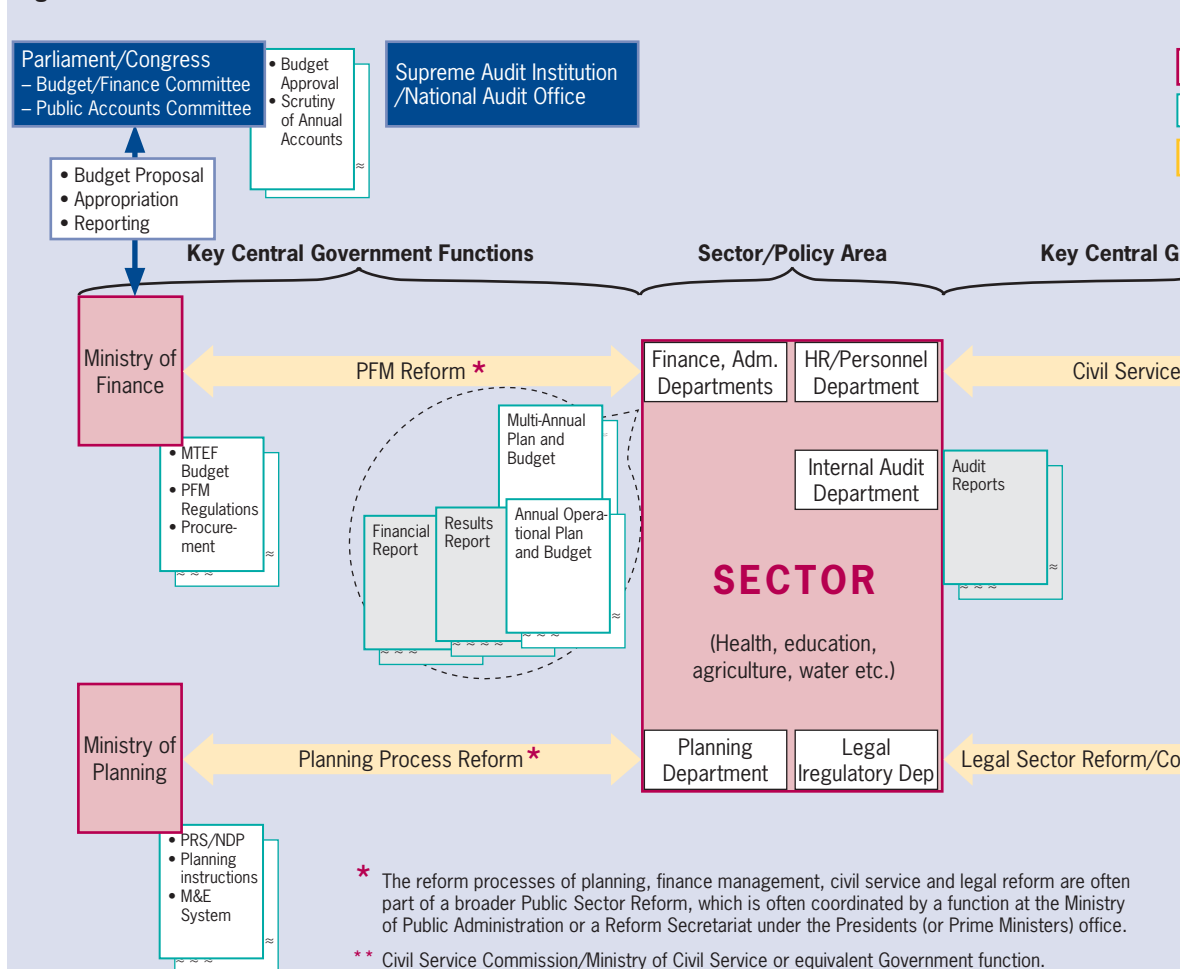
- **The link between general PFM capacity and PFM capacity in the sector**
- **The importance of alignment to government procedures and systems in the sector**
- **PFM assessment in the sector and why it is needed**
- **Definitions of different concepts in the sector**
- **How to handle situations with weak PFM structures in the sector**
- **PFM capacity in the sector**
- **The guiding documents in sector work**
- **Sector projects in the light of alignment**

4.1 Introductory Definitions

The starting point of Sida's programmes of cooperation should be, as far as possible, a **Programme-Based Approach PBA**, in line with the implications of the Paris Declaration. This kind of collaboration covers cooperation in the form of both sector programmes and individual projects, since projects also normally represent one part of a sector. It also covers programme cooperation in cross-cutting areas such as public service reform or reform of the judiciary.

With this as its point of departure, the chapter is structured from the concept of a sector programme. It also includes guidelines for working in the form of project cooperation as far as PFM issues are concerned. In principle, these guidelines are also applicable to co-operation in cross-cutting programmes. **The Government's sector programme is a planning tool for the coordination and integration of support to the policy, plans and activities of the sector. It should be clearly separated from the financing mechanisms used to support the programme or the project (see below).**

Figure 4.1 The Sector's Relation to Different State Functions at Central Level



4.2 Introduction

4.2.1 PFM is Both a Sectoral and General Issue

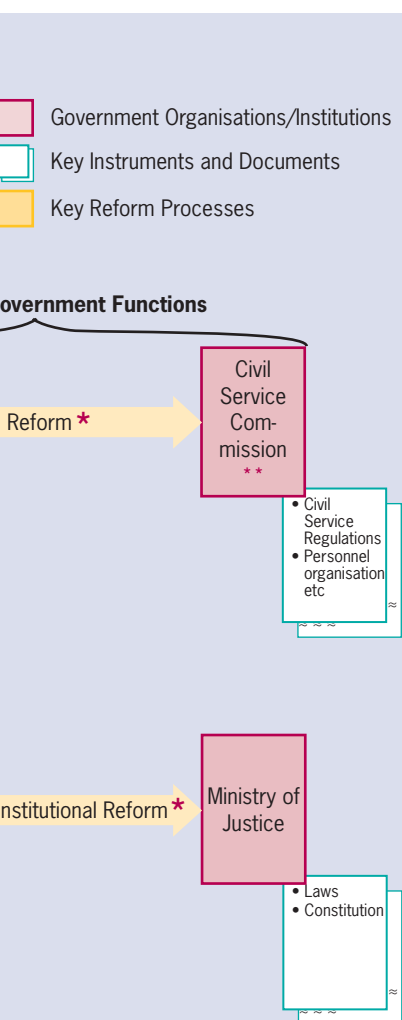
Figure 4.1 aims at giving a broad view of the relationship between the sector and most important cross-cutting institutions in the state. When analysing PFM in the sector, it is important that one relates to the key government functions shown in the figure (MoF, etc.), their key documents (planning and budgeting instruments, follow-up reports and audits), and reform processes. All PFM assessment and reform initiatives in the sector should relate in a coherent way to them. Bottlenecks regarding PFM performance could also, sometimes be sought outside the sector.

PFM is a key support area for results achievement in both overall government operations (through MoF as the coordinating institution) and in the sector. The perspectives and focus of PFM vary somewhat between, on the one hand, the *Ministry of Finance* and other cross-sectoral institutions and, on the other, the sector itself. The PFM system defined by the MoF mainly focuses on its needs to control overall government spending and improve allocative efficiency across sectors. It is normally the MoF that defines the rules of the game regarding financial management across government, including those for the sector. Sometimes, it is also in charge of staffing issues in the PFM-related functions at the sector ministries. The needs of the sector to achieve quality and efficiency in spending within and across programmes, and to combine financial information with information on results achieved, are not always given sufficient consideration in the cross-cutting PFM reform led by the MoF. **The relationship between the sector**

ministry and the Ministry of Finance, as well as their respective powers and capacity (in absolute as well as relative terms) to fulfil their mandates, will **influence the extent to which the sector will ultimately be able to reach its objectives**. In some countries, the MoF is too strong in relation to the sector and might dictate terms that are not conducive to the sector's development. In other cases, the legitimate power of the MoF has been undermined, for example by direct support from development partners to sector ministries that have not been part of the overall government resource allocation decisions. Hence, PFM in the sector must be seen as combination of PFM conditions and needs at both MoF and sector level. In light of the desire to create coherence between plans and allocated resources in the sector, it follows that **the sector has partly different needs and expectations** in relation to a PFM system, than those of the *Ministry of Finance*. (This reasoning is valid also for several other cross-cutting support systems of the government such as human resource management, planning and decentralisation.)

Hence, when looking at PFM performance in the sector, it is important to have an understanding of the following:

- the overall PFM system that the sector is part of and needs to operate within;



- the position of the sector within that overall PFM system;
- the additional/complementary PFM systems/procedures that the sector needs for its efficient management of resources; and
- how the general (horizontal) PFM systems at the MoF integrate with the sector's complementary systems (vertical).

4.2.2 Alignment as a Way of Enhancing Overall Results

When supporting the sector, Sida should always strive for as much an aligned, harmonised and untied aid modality as possible. The more “on” Government systems the support is, and the fewer the special safeguards are, the better the support will be in terms of enhancing the effectiveness of the domestic PFM systems. By working outside the government's PFM systems and procedures, development partners may miss the opportunity to assist in the strengthening of government systems. What is worse, however, is that **by working outside the national PFM system development partners may also undermine their credibility and reduce their effectiveness** through, among other things, the incentive systems that follow from by-pass solutions (cf chapter 2, alignment).

PFM systems in sectors receiving development assistance often under-perform in comparison with internationally established PFM standards, both in respect of PFM for efficient service delivery and governance-related areas such as scrutiny, accountability and transparency. That is part of the reason why development assistance is requested. However, it is only by placing as much reliance as possible on government systems that real demands for their improvement can be generated. **The sector-wide approach aims to offset the weaknesses of traditional project support.** It does so firstly by supporting a government-owned policy and strategy, secondly by promoting coherence between policy, budgeting and results, and thirdly by reducing the transaction costs of utilising parallel procedures to those of the government. There is a need to work with and within the systems, given that they are weak, and design the support in a way that enhances the improvement of these systems, while at the same time strive to minimise both development and fiduciary risks.

The choice of aid modalities that operate in parallel to those of the government can often become counter-productive to their purpose, since **what counts in the end is the overall application of resources and total output and quality of services provided** – not merely the output of the marginal support provided by one development partner. Additionally, due to fungibility¹⁶, even if development partners, individually or as a group, earmark their support to specific activities, this does not provide a guarantee of output and quality of services in that specific area. **Earmarking** also ignores the importance of overall allocation of resources in the sector in order to meet overarching policy objectives. In most cases, it is better to choose a better aligned aid modality and be part of the dialogue on overall resource allocations in the sector. Focus should be on improving the ability of the national PFM systems to channel and register resources for effectively implementing the plan. It is highly recommended that you read more about earmarking in Appendix 1¹⁷.

¹⁶Fungibility is defined and discussed in Appendix 1.

¹⁷For a definition and discussion of earmarking and additionality see Appendix 1.

Hence, when choosing a financial modality, **the starting point should be the most untied and aligned aid modality of all – non-earmarked budget support.** Any deviation from this aligned financing modality in terms of safeguards and/or parallel procedures should be justified, taking the above-mentioned aspects related to factual results and alignment into consideration.

A focus on alignment with national systems could help development cooperation to **enhance the poverty focus through a rights’ perspective and poor people’s perspectives on development.** Allowing the government to make priorities among all available resources in relation to its policy objectives should enhance domestic accountability – in relation to parliament and citizens – rather than accountability in relation to development partners. The inclusion of all funds in a joint planning and budget framework should improve the transparency of overall resource allocation and public expenditure in the sector, and thereby form the basis of increased participation and focus on service delivery to marginalised groups. Hence, improvement of PFM, and alignment to national PFM systems in the sector, should support democratic development, and contribute to both improved service delivery, and an improved situation where citizen rights are concerned.

4.3 Sector Programme Support

4.3.1 Definitions

A **Sector-Wide Approach** (SWAp) is a process in which funding for the sector supports a single policy and expenditure programme, under government leadership, and adopts common processes across the sector. The SWAp aims at applying the principles of harmonisation and alignment included in the Paris Declaration.

A SWAp can be supported by any of the below-mentioned financing mechanisms (ways of financing sector activities included in the SWAp): domestic government funding; budget support, basket (or pooled) funding or project financing:

Budget Support is defined as a financial contribution to the partner country’s national budget, which is channelled into the general treasury account where, as an integral part of the resources therein, it co-funds the national budget. The support is normally not earmarked, and it is used in accordance with national public expenditure management rules and procedures.

Basket funding (or pooled funding) is the joint funding by a number of development partners of a set of activities through a common bank account. The planning and other procedures and rules governing the basket fund are common to all development partners, but their conformity with the public expenditure management of the recipient government and of sector conditions may vary.

Project funding is an individual development intervention designed to achieve specific objectives within specified resources and implementation schedules, often within the framework of a broader programme, in most cases a SWAp.

In reality, though, support from different development partners (in some cases even from the same development partner) to the same activity (project/programme) is often a mix between the different alternatives above. To complicate matters further, there are no internationally agreed definitions of these financing modalities and they vary somewhat

between different development partners. In that context it is important to note that General Budget Support and Sector Budget Support is the same modality from a financial point of view, i.e. budget support, although the scope of cooperation differs (cf chapter 3 – Budget Support Definitions).

The differences in approach to PFM between different aid modalities are also gradually being reduced. The aid effectiveness agenda implies that all support, regardless of aid modality, should be implemented in a way that promotes alignment, harmonisation and local ownership as much as possible.

The Paris Agenda means that, even in cases where the project support modality is chosen, Sida should strive to adopt a sector-wide approach for this support and, as far as possible, promote the use of national PFM systems.

4.3.2 The ideal situation for a sector programme and its funding modalities

The basic principle for a sector programme is that all support provided by external parties – regardless of the form of support – is subordinated to the objectives of the country’s strategy for the sector.

The ideal situation for a SWAp is where the sector has a clearly defined policy, together with consistent objectives and a medium-term operational plan (3–5 years) with a logically linked and realistic expenditure programme, in line with national poverty reduction priorities and backed by a realistic *Medium Term Expenditure Framework*, including all financial resources available to the sector. From this plan and expenditure framework, an annual operational plan and budget in a programmatic format should be derived. The multi-annual plan and budget are revised annually. There is a good institutionalised dialogue between the sector and the MoF, and between the sector and its development partners.

The donor community has subscribed to the sector policy, objectives and the expenditure framework, they work together in a Working Group, and there is at least one annual review to follow up the achievement of objectives and budget execution, in one joint exercise for all sector stakeholders. One common planning, budget, and reporting format has been agreed upon and no reporting outside this format is necessary. There is a common set of result indicators, formulating the point of departure of the annual review and formulation of new objectives. Audits are made jointly of all funds in the sector programme, mainly relying on the internal audit of the sector in combination with that performed by the national audit office. All development partners provide timely financial information regarding their pledges, adapted to the national budget cycle. Donor disbursements are timely and predictable, in alignment with the cash-flow plan of the sector. Most development partners, including Sida, give non-earmarked support to the sector plan and budget through GBS, SBS or a pooled fund with most procedures aligned with government systems. Clear benchmarks have been set for the improvement of PFM systems and, with respect to this, development partners have committed to go increasingly “on-systems” and gradually remove additional safeguards. Agreements are reflected in a sector-wide code of conduct (or equivalent) for all parties that want to support the implementation of the sector plan and through a MoU/JFA for all development partners that provide their financial contribution through budget support and/or a basket fund.

In reality, the situation described above is very rare. Development partners impose various restrictions on the use of their support, insist on various routines, and draw up separate time schedules for their support. These restrictions are often counter-productive to developing and sustaining capacity and may also negatively affect the development results in the medium to long term. One such restriction which often is discussed is “additionality”, i.e. the notion that the contribution must be additional to the partner government’s budget. Additionality requirements can severely undermine the budget process – read more about this in Appendix 1.

4.4 Assessing PFM in the Sector

4.4.1 The rationale for a separate sector PFM assessment

The overriding reason for carrying out a PFM assessment in the sector is the basic fact that the Ministry of Finance (and ministry or entity of planning if there is one) on the one hand, and the sector ministries on the other, partly have different interests in the design of PFM procedures and information needed from PFM systems.

The PFM needs of sectors mainly focus on systems and procedures that will make it possible to implement sector plans and programmes in an efficient manner, whereas the MoF is more concerned with macro-economic stability and overall Government allocative efficiency. Below, in table 4.1, some examples are provided of situations where the financial information needs may differ (although these aspects vary substantially between countries).

Table 4.1 PFM needs of the MoF and the sector

Issue	MoF interest/needs	Sector ministry interest/needs
Classification of financial information	The MoF often places a strong emphasis on economic classification (cost items such as investments, salaries, other recurrent expenditure etc). In order to promote overall allocative efficiency, it not seldom introduces programmatic classifications, often based on international financial statistics standards (COFOG). ¹⁸	The sector (in addition to the needs of the MoF), often needs to present its financial information in another format than the international programmatic standards prescribe. To manage its resources efficiently, its programmatic format needs to follow the programmes under which it implements activities (Example health sector X: a) HIV/AIDS; b) primary health care; c) preventive health care etc. This is also called management accounting (i.e. relating financial information to formulated objectives and expected results). It facilitates accurate calculation of costs for reaching certain objectives and thereby forms the basis of a more relevant budget dialogue with the MoF on both the annual budget and the multi-annual MTEF.

¹⁸ A programmatic classifier in the budget is often offered by the MoF. However, it is not certain that this answers to the needs of the sector (that might work differently from, for example, the COFOG classifiers). From the sector point of view there is also a need that the same programmatic format is reflected all the way from the multi-annual plan to the accounts. This is often not a concern of the *Ministry of Finance*.

Issue	MoF interest/needs	Sector ministry interest/needs
Planning and monitoring of all expenditure in a holistic manner	The division of labour in some governments is as follows: the MoF makes decisions on recurrent expenditure control, and the Ministry of Planning (or equivalent) makes decisions on investment expenditure. Procedures and IT tools for this are often not integrated. This risks undermining the ambition to make efficient overall expenditure decisions in the implementing sectors, and supports the rationale that the sector is often better off managing its own financial resources.	The sector needs to link different kinds of expenditure to the same objectives, i.e. calculate the total cost (and projected future costs) of a certain investment or other expenditure to ensure efficient use of resources. The same goes for linking the cash flow of different kinds of expenditure (investments, recurrent costs) to ensure that resource availability is coordinated and timely.
Accurate cost calculation system	In some cases the Ministry of Finance provides a cost-calculation model that does not correspond to that of the sector, which may lead to substantial additional work, since the budget calculation data needs to be entered into the budgeting/programming system twice. In the worst scenario, the sector's cost calculations become less accurate as a consequence of using the MoF-designed IFMIS system.	The sector ministry needs to develop a model for cost calculation that is based on its collected data and adapted to the way resources are spent in the sector (link plan and budget). Depending on the sector (level of standardisation of services), the sector can sometimes use the national system. However, it is important that the national system, if possible, allows for cost-calculation systems in the sector that are adequate for its programming, budgeting and monitoring needs.
IFMIS and other management information systems	The IFMIS system of the MoF is not always designed in such a way that it is possible to link to the sector's other IT systems (through additional, linked applications). By closely involving the sectors in the design of the IFMIS system, parts of this problem could be overcome.	The sector often has its own management information systems (for tracking service delivery, staff, input material and results information), which it wants to integrate/connect to the MoF-designed IFMIS-system, to ensure its results information is adequately linked to the PFM system. The MoF needs to ensure that the IFMIS system it installs across Government is designed in such a way that this linkage is possible to make (see chapter 7 regarding standardised versus custom-made IFMIS systems).
PFM staffing	In cases where the MoF is also in charge of PFM staffing at sector ministries, it normally only focuses on general PFM skills and overall skills provision at a macro level.	The sector may be in need of PFM staff that are not only skilled in PFM but also understand the nature of the operations of the sector, and hence can apply PFM-systems in an efficient manner, given the objectives and nature of operations in the sector. The sector also ideally needs to be involved in the decisions regarding secondment of PFM staff to its area, in order to take responsibility for PFM-related reforms in its operations.

Issue	MoF interest/needs	Sector ministry interest/needs
Consideration of conditions at sub-national level for effective PFM	PFM systems designed by the MoF often have their main focus at the central level and, at times, do not always give sufficient attention to the needs and conditions for PFM at the decentralised level (e.g. IFMIS implementation in remote communities without electricity or a centrally defined budget cycle). Sometimes, legislation related to PFM does not sufficiently consider the different conditions at the local level or regional variations in infrastructure etc.	The sector often needs to involve lower administrative levels in its budgeting and follow-up processes in order to ensure efficient budget execution and relevance of services provided.
Procurement and audit	Some aspects related to both procurement (special goods) and auditing (special procedures) may be rather specific to the sector. This requires staff and procedures that are adequate for the sector to perform these tasks effectively.	

4.4.2 Ambition Level of PFM Assessments in the Sector

There is often a need to **enhance PFM in the sector as part of overall sector programme development**. Hence, the sector, jointly with its partners in the sector programme, can decide to make a **joint sector PFM assessment** as a basis for the design of PFM reform in the sector. When making a PFM assessment at sector level, the conditions created for the sector by the MoF should always be included in the analysis. This means that diagnoses of the country's general PFM systems – such as PEFA, CFAA, DFID's FRA, IMF Article IV consultations, etc (see chapter 5!) – should always be studied as part of an attempt to assess the PFM situation in the sector

When preparing a contribution to a sector, there is a need to make an assessment of PFM conditions in the sector. Even though programme support does not involve any major changes to the different stages in Sida's internal decision-making process presented in *Sida at Work*, the challenge is rather that the different assessment criteria require that PFM, among other things, is taken into account. For instance, to assess effectiveness there is a need to consider if the sector budget is in line with the sector plan and poverty-oriented.

An assessment for preparing a contribution needs to fulfil Sida's requirement to make a well-informed decision on sector programme support, and to guide Sida in the management of the contribution. The ambition level of the PFM assessment should be balanced against other types of capacity assessments needed for contribution preparation and follow-up. The ambition level should also be reasonable in relation to the size of the Sida contribution and the overall programme. The information should be as concise as possible, identify major issues, explain the importance of these, and suggest priority actions for Sida, such as conditions for support, risk-mitigating measures, aspects to follow up, and dialogue issues such as identified needs for reform. It should be based on previous analytical work (both overall and sector-specific analyses) as much as possible. Sida should avoid making information demands on its partner exclusively for Sida's internal decision processes.

The two needs for PFM assessment described above (1. the broader, joint assessment aiming at PFM reform planning, and 2. the assessment for contribution prepara-

tion purposes), although ideally combinable, normally represent very different levels of ambition. While the first would normally be more comprehensive, depending on the context and existing analyses, the **Sida assessment as part of the contribution preparation should, at the very least, answer the following key questions:**

- Is the sector plan realistic and feasible given the medium-term financing scenario (MTEF)?
- Is the sector budget in line with the sector plan and PRS, and poverty-oriented?
- What are the major risks and constraints of the PFM system affecting service delivery and democratic governance in the sector?
- Are these risks handled in a credible and prioritised manner?
- What do the conclusions above mean for the prospects of the sector programme of reaching its desired results for poor people (use *Sida at Work* criteria)?
- What do the conclusions above mean for the Sida contribution (design of funding modality, dialogue etc)?

4.4.3 Issues to Consider in a Sector PFM Assessment

The following are some PFM-related issues (in the broad sense) concerning the sector that arise when preparing sector programme support. They should provide guidance for assessing PFM systems in the sector, in the context of sector PFM reform, design of aid modality, and/or the preparation of a Sida contribution. The level of ambition differs depending on whether the sector PFM assessment is mainly done as part of a Sida contribution preparation, or as a larger joint exercise aiming at PFM reform in the sector.

The column on the left summarises what is important to know about each PFM area (1–10), and the column on the right provides some guiding questions that could assist in acquiring this knowledge (they should be regarded as a form of support and not as compulsory questions that need to be answered in the assessment).

Table 4.2

PFM issue/area	Questions to guide the assessment
<p>1. The sector plan and the planning framework</p> <p>It is important to know what regulative frameworks, and planning and budgeting instruments, that affect the sector's planning and budgeting, and to be aware of what forms of support/constraints these represent for the sector's planning and budgeting process.</p>	<ul style="list-style-type: none"> a) How is the sector defined? b) What is the basis for support? c) What is included in the sector plan (which might be a PRS or NDP)? d) What is the legal framework for the sector and its level of consistency with international conventions on human rights and other commitments? e) What are the priorities in the plan? How are poor women and men, and marginalised groups, likely to be affected? Who participates in the formulation of the planning framework and the plan/budget, and to what extent is there a participatory follow-up mechanism? f) Does the government have a reliable and adequate MTEF? g) Are the different planning instruments of the government (PRS, MTEF, Sector plan) coherent and consistent?

PFM issue/area	Questions to guide the assessment
<p>2. Budget policy in the sector</p> <p>A budget policy analysis should give information on the coherency of actual budget allocations in relation to policy priorities, coherency between different budget instruments, and the distribution of the budget in different expenditure categories. It is important to ensure that policy priorities are translated into actual resource allocations in order to reach the desired objectives.</p>	<ul style="list-style-type: none"> a) Do the sector budget allocations reflect national and sector priorities? b) Have the sector and its partners agreed on predictable criteria for resource allocations based on policy, and are these criteria respected? c) What distribution (and trends in distribution) can be seen between different cost items such as salaries, investments and other recurrent costs? d) Are there any funds for operational activities? Does the distribution of resources between central and local levels reflect the poverty reduction objectives? e) What are the implications of the budget allocations from a human rights and poverty perspective (men/women, geographical/regional, urban/rural, types of services, priority target groups, the environment etc)? f) What financial statistics exist that can support informed decision-making related to different groups of citizens, i.e. women/men, marginalised groups etc. g) Are the budget allocations broadly consistent with the MTEF and the PRS? h) Is the budget process transparent and democratic?
<p>3. Annual operational plan and budget</p> <p>In order to be trustworthy (including it being based on realistic cost-calculations), the operational budget must be detailed enough to use for implementation, and as the basis for the follow-up of results.</p>	<ul style="list-style-type: none"> a) What is the quality and comprehensiveness of the annual operational plan (AOP) and its budget (ideally these two form one integrated document)? b) Is the AOP/budget consistent with the priorities of the multi-annual sector plan, the MTEF and the annual budget? c) Is the AOP/budget realistically costed and can different sources of funding be identified? d) Does the AOP/budget have clear priorities, also given different financing scenarios? e) Is the AOP operational as a management tool (i.e. include different levels of details for different actors) for different levels of the organisation? f) Can the AOP/budget be used as a basis for monitoring and evaluation? g) Are the mechanisms for reallocation of funds in the budget in-year transparent and timely?
<p>4. Results orientation within the sector</p> <p>From a PFM perspective, it is essential that the definition of result indicators/targets are realistic in relation to the funds allocated for this purpose (it is not unusual that targets are set without adequate calculations of how much it will cost to achieve them, which may lead to non-realistic performance indicators).</p>	<ul style="list-style-type: none"> a) What indicators will be followed-up in the programme? Are these indicators endorsed by all actors in the sector (no separate lists of indicators)? b) What types of indicators are being used – process and/or result indicators? c) Are there indicators which reflect a rights' perspective and the perspectives of the poor on development? d) Are the indicators realistic in relation to capacity? e) What is the link between achievement of results and resource allocations (RBM system)? f) How are statistics collected? What is the quality of statistics?

PFM issue/area	Questions to guide the assessment
<p>5. Flow of funds (at macro and sector level)</p> <p>The timely allocation of funds (and other resources) to implementing units is decisive for service delivery and achieving results. Possibilities of making funds available to different parts of the organisation are therefore crucial.</p>	<ul style="list-style-type: none"> a) Do funds reach the sector and its service delivery units on time? b) Are they effectively transformed into service delivery? c) What are the main bottlenecks to effectively spending the resources at local/decentralised level (cash flow planning, lack of financial autonomy, poor financial reporting, information to the planning and budget formulation, etc)?
<p>6. Procurement</p> <p>Reform activities in sectors almost always include a number of extensive procurement processes (such as construction or maintenance of schools, roads, health clinics), and in some cases represent very important supplies (such as medicines in the health sector). It is of great importance that procurement processes are the subject of controls and made transparent for the efficient use of financial resources in the sector.</p>	<ul style="list-style-type: none"> a) To what extent are central procurement regulations adequate for sector procurement? b) Are there special procurement arrangements for the sector only? Sector-specific legislation or regulations? Sector-specific procurement structures or departments? Are these regulations relevant? What is the status of the sector-specific organisation? c) To what extent can procurement in the sector utilise government regulations and procedures (should be utilised to the maximum extent)? What additional regulations/arrangements have to be added and how is necessary government capacity in this field included in the procurement process irrespective of the intermediate use of external regulations/arrangements? d) See further section 5.4.7 on guiding documents for procurement!
<p>7. Financial reporting and control</p> <p>The extent to which the flow of funds and expenditure in the sector is possible to track and record is important for ensuring that budget allocations are matched by actual availability and usage of funds for intended activities. Regular financial reporting and scrutiny of this reporting provides the basis for this assessment.</p>	<ul style="list-style-type: none"> a) What reports exist on the financial execution of the budget and other sources in the sector? b) Is there parallel financial reporting due to separate funding by development partners? What does this mean for the possibility to manage the flow of funds effectively? c) Are there budget follow-up reports? d) Are there annual accounts? e) What information is available through these documents for the sector? Is it trustworthy? f) Is it being scrutinized and checked? g) What accountability mechanisms for financial control are there? h) Is there an effective internal audit? How are its reports followed-up? i) Is there a supreme audit institution that presents an audit report on the government's annual accounts including those of the sector?

PFM issue/area	Questions to guide the assessment
<p>8. Institutional Capacity</p> <p>The capacity of a sector to manage its financial resources effectively and efficiently is largely dependent on its management set-up, PFM skills possessed by the staff, as well as the relationship between the sector and the MoF (and other cross-cutting government organisations). It is therefore useful to analyse PFM-performance from a capacity development point of view.</p>	<ul style="list-style-type: none"> a) Is there adequate leadership/management in the sector to lead and steer the sector programme over time, especially in the planning and finance area? b) Is the annual budget process coordinated between planning and budgeting, in relation to the MoF and internally at the sector ministry? c) Is there adequate capacity in the sector to effectively implement the programme (PFM and other skills), both at central and decentralised levels? d) Does the sector ministry have the capacity to negotiate with the MoF for allocation of funds to the sector and to match the MoF throughout the budget process? e) Does the MoF have the capacity to facilitate the work of the sector ministry, for instance by providing information and training as regards new modalities such as the MTEF or technically through provision of, for example, new budget structures?
<p>9. Financing modality for the sector programme</p> <p>The choice of financing modality is likely to influence PFM-performance in the sector and vice versa. Hence this choice needs to be explained in a way that: i) presents the pros and cons of the financing modality from a broad PFM development perspective, and ii) shows a clear way towards more alignment of the support (if not already 100% aligned).</p>	<ul style="list-style-type: none"> a) What are the rationale and effects of choosing another financing modality than non-earmarked budget support? b) In case any parallel mechanisms/safeguards are introduced, what will the step-by-step change towards a more aligned modality look like?
<p>10. Conditionality</p> <p>The effect of other conditionalities on PFM performance, as well as the development effects of PFM conditionality as such, should both be analysed. Conditionality (at sector and central level) should be beneficial to sustainable PFM development in the sector.</p>	<ul style="list-style-type: none"> a) Are disbursements linked to the achievement of results (output or outcome indicators)? b) Is this done in such a way that management for development results is enhanced? c) Is sector conditionality coherent with GBS conditionality? d) Is there a regular presentation of indicators that is sufficiently strong to support a discussion on results?

4.4.4 PER and PETS

Two important tools for assessing public finance management in programmes of development cooperation are *Public Expenditure Reviews* (PER) and *Public Expenditure Tracking Surveys* (PETS). Both are diagnostic instruments developed by the *World Bank*, but they are increasingly being internalised as regular features in the budget process of partner countries. Diagnoses are carried out on both general, cross-sectoral PFM issues and systems, and on sector-specific issues. Compared to other diagnostic instruments such as the PEFA, which focus on the performance of the technical system, **PER and PETS focus more directly on the budget and its implementation**, thereby making it possible to identify bottlenecks and limitations in PFM capacity in the sector (and in general systems) and ways in which this affects service delivery.

One important question is how the area of analysis is defined in these diagnostic tools. Obviously, in an ideal world of local ownership, before undertaking such an analysis there should be consultations with the government, so that those who know most about the context can define what the problems are. However, analyses are in many cases driven by development partners.

PER is primarily a tool for budget analysis.¹⁹ It assesses whether the budget (sector or state) is implemented in line with policies and allocated efficiently. It may also include analysis of operational efficiency, i.e. if there is value for money by relating inputs to outputs. Undertaking public expenditure reviews to improve resource allocation is an important element in the budget process although it may not be required every year. In reality, the introduction of a PER includes the possibility of analysing any PFM-related issue, individually or in relation to more complex patterns, such as legislative implications on planning procedures or budget execution.

PETS is a narrower instrument than PER since its **focus is on tracking the flows of funds to the beneficiaries** (teacher salaries, grants for schools etc.).²⁰ This implies more depth, but it is assumed that the problem is that funds do not reach the beneficiaries, although it may include or comment upon problems relating to service delivery that are broader than flows of funds (even if this often is a severe constraint).

PER and PETS are strong and relevant instruments to be used in both general and sector specific PFM analyses, all through the chain of events in the budget process from planning to audit. They can also be used to identify PFM capacity constraints relating to the implementation of poverty programmes. Still, they must be valued on their capability to present unbiased analyses of weaknesses in PFM capacity in relation to the objectives of allocative and operational efficiency. PER and PETS analyses are, in most cases, not sufficient as analyses. Other aspects outside the PFM area also contribute to constraints to the fulfilment of policy intentions, for example civil service regulations. Nevertheless, existing PERs and PETS should always be consulted as part of a PFM assessment in the sector.

In some countries, PERs have been institutionalised as regular parts of the annual planning and budgeting cycle. It is important that these instruments, both PERs and PETS, whether they are applied annually or less frequently, are used on a regular basis. They should also have a scope and an ambition that is reasonable in relation to the overall expenditures in the sector.

Implications for Sida

In order to succeed in the sector dialogue, the key is to be prepared. If a programme officer knows what kind of instruments the PER and PETS are, knows their shortcomings and advantages, and has formed an opinion based on this in the case in question, it is easier to influence the arrangement of the next study. From a Sida perspective, the service delivery aspects of PERs and PETS should be enhanced on the basis of an identification of problems in each individual case. What is essential is that services and goods reach the poor.

¹⁹ www.worldbank.org/Topics/Public Sector Governance/Public Finance/Core reports/Public Expenditure Reviews.

²⁰ www.worldbank.org/Topics/Public Sector Governance/Public Finance/Public Expenditure Tracking Surveys.

4.5 Handling Weaknesses in PFM with a Focus on Alignment

The above-mentioned sector PFM assessment should identify conditions for democratic governance, service delivery, and fiduciary risks of the PFM system in the sector.

Some examples of common and important PFM-related weaknesses in the sector are listed in the table below, together with some suggestions on ways of dealing with them. The table has been divided into problems/weaknesses, short-term mitigation and long-term solution approaches respectively. These are merely indications of the approach to be taken and depend, to a great extent, on the actual context in each individual case. However, they all take an alignment approach to the handling of PFM weaknesses.

Table 4.3 Examples of ways to handle PFM weaknesses with a focus on alignment

	Problem/weakness	Short-term mitigation	Medium-term solutions
Macro policy and planning	MTEF is not reliable or not sufficiently linked to policy priorities. Unclear resource allocation criteria for the sector.	Agree medium-term allocation levels to sectors with the MoF.	Support the development of a coherent MTEF, combining top-down and bottom-up perspectives. Support the sector in developing its plan and budget, in order to provide an adequate basis for budget negotiations with the MoF
Budget policy and formulation	Unclear or non-consistent resource allocation criteria within the sector, for instance to service delivery units, or to different cost items such as salaries vs. other expenditure.	Formulate initial principles for resource allocation between administrative levels and programmes, or for parts of the funding. Monitor budget allocations and actual disbursements within the sector in semi-annual and annual reviews, and discuss these from a policy and poverty reduction perspective.	Support the line ministry in developing overall resource allocation criteria for all funds based on the sector policy, and a transition plan from the current system to a new resource allocation system coherent with this policy. Continue and refine budget allocation and disbursement monitoring against agreed policy targets.
Budget policy and formulation	Rule-based resource allocation criteria to or within the sector not compatible with sector plan or poverty focus (e.g. constitutional requirements of funding in % of the ministry's budget to specific areas such as tertiary education)	Reach an agreement to exclude development partner support from the allocation criteria. As a last resort, place the sector programme support off-budget in a formal sense (exclude the support from the budget document) while making every attempt to provide information on allocations, reports on disbursements, and using the format of the regular system.	Initiate dialogue with the government on reforms to address/abolish allocation criteria that determine overall sector resource allocations as they are working against the basic principles of budgeting. Define benchmarks for the phase-out of such criteria at an overall government level and in the sector. Monitor annual progress towards these benchmarks.

	Problem/weakness	Short-term mitigation	Medium-term solutions
Budget policy and formulation	Lack of reliable cash provision from the MoF and development partners to the sector.	<p>Support the improvement of cash-flow planning in the sector ministry or MoF depending on where the problem lies.</p> <p>Support improved financial reporting from sector to MoF. Unify reporting on government and development partner funds to ensure comprehensiveness.</p> <p>Improve predictability of development partner disbursements – include a joint disbursement mechanism as part of the JFA/MoU.</p> <p>As a last resort, during a transition period make direct disbursements to the relevant level of the organisation, (depending on where the payment problem lies), in accordance with overall agreed budget allocations. Make sure that these disbursements are known to the MoF, and reflected in the sector's budget execution reports.</p>	<p>Encourage adequate and transparent criteria for payment prioritisation across government.</p> <p>Support the development of mechanisms for improving the link between the plan and the budget, both in the sector and at overall government level.</p> <p>Support the improvement of the government's overall forecasting model and cash management.</p>
	No programmatic budget or accounting structure based on sector plan	<p>Encourage a separate Excel spreadsheet system for the presentation of the budget in a programmatic format, alongside the presentation merely based on cost-items (i.e. salaries, transfers, operations, etc)</p> <p>Encourage awareness training on programmatic budgeting in the sector</p>	<p>Encourage dialogue with the MoF on adapting the account structure and budget presentation format in accordance with sector needs. Introduce a model for including all expenditure under programmes, including both recurrent and development expenditure.</p> <p>Ensure that the MoF considers the needs of the sectors, through the dialogue with MoF on the overall PFM reform.</p>
PFM Capacity	No single focal point for planning, budgeting and control of financial flows in the sector	<p>Define coordination mechanisms between PFM-related departments in case these functions are separated.</p> <p>Regulate, as part of the harmonisation of documents in the sector (CoC or equivalent), the obligation for all financing to the sector to be included (at least visualized) in the budget and reported upon in the same structure. This implicitly means informing the sector's budget/finance administration about the financing.</p>	If necessary and possible, encourage the re-design of the organisation of the sector's departments responsible for planning, budgeting and finance administration, to have all under one umbrella.

	Problem/weakness	Short-term mitigation	Medium-term solutions
Budget execution (payments, accounting and reporting)	Weaknesses in payment and accounting system, such as delays in reporting or reporting only based on cost-items and not related to activities or programmes. Weak reporting on budget execution causes delayed releases or fragmented releases not based on spending priorities, for instance due to separate financing of certain items which are not covered in reporting to treasury.	Support the sector with training and TA (in positive watchdog format) to support getting the basics of accounts reconciliation right. Support the sector in a similar way to set up a simple system for monitoring expenditure returns, based on one joint simple reporting format. Encourage sector PERs and PETS to track expenditure based on programmes, until the programmatic format is in place.	Accept good reports in cost-item format initially, and encourage the development of reports in programmatic format in the medium term. Encourage the involvement of the internal audit department in supporting the development of these systems, through reviews and recommendations regarding the systems.
	Decentralised levels unprepared to manage funds efficiently.	Ensure that user-friendly finance management manuals and training are available at this level. Provide TA and extra resources to ensure adequate monitoring and an audit mechanism for this level.	Encourage the sector to develop a plan for ensuring adequate PFM staff at this level, as well as an adequate level of fiscal decentralisation Include the development of a monitoring mechanism for fund flows and expenditure returns in the sector PFM reform plan. Introduce technically simple computerised support systems for accounting and reconciliation of accounts linked to the central IFMIS system
Procurement	Weak regulations and procedures for procurement in sector.	Use the national system for minor procurement and international standards (one set agreed by all) for procurement above certain thresholds. In-year audits of a sample of procurements. Make all procurement information transparent for all stakeholders. Participation of external experts in procurement committee. At decentralised level, encourage simple cost-efficient systems, such as regulations of maximum price for certain standard goods/ services.	Encourage the review of the regulatory framework and the actual procurement process, with the aim of ensuring a cost-efficient procurement from all points of view (decentralisation, economies of scale, and corruption risks). Closely monitor progress in the procurement area in order to remove safeguards as soon as possible.

	Problem/weakness	Short-term mitigation	Medium-term solutions
Audit	Weak internal and external audit function Weak ability to follow-up audit recommendations.	Engage an additional external audit firm to perform regular audits in the sector. TA hired in the PFM area should also contribute to capacity building of the internal audit department to perform regular audits in the sector.	Include capacity development activities for the internal audit department in the sector PFM reform plan. Continuous monitoring of the national audit office (NAO) capacity to perform qualified and timely audits in the sector should be done, as a necessary precondition for being able to completely abolish external audits (in addition to the NAO's). Include capacity development activities for NAO and parliamentary institutions concerned. Encourage the installation of a sector audit committee to overview the follow-up of audit recommendations and provide support to management regarding PFM improvement.

4.6 The Guiding Documents for the Sector Programme

The sector often develops joint steering/guiding documents to support the development of the SWAp and its related joint financing arrangements. Apart from domestic legislation and financial management regulations and the government's guidelines for the budget process, there are often several other types of documents that guide the sector's work processes in relation to international cooperation and external contributions to the sector. There are, in most cases, both bilateral and multilateral agreements for this purpose, often one or more non-legally binding document that directly or indirectly guides cooperation in the sector programme and the implementation of good international cooperation practices, i.e. the Paris Declaration.

These documents – the **Code of Conduct** and the **Joint Financial Arrangement** (or MoU) – are often the key documents for regulating PFM issues related to joint financing and contributions to PFM reform in the sector and, at the same time, for promoting alignment to the overall PFM systems in the sector and country. Sida should be present and well-prepared for facilitating the drafting of these documents in a way that enhances national ownership, alignment, and PFM capacity development in the sector.

4.6.1 Code of Conduct/Partnership Principles

Many sectors/countries find it useful to regulate the participation of *all* contributors to the sector – irrespective of the financing modality chosen – in a gentleman's agreement often given one of the following names: *Code of Conduct*, *Partnership Principles* or *Memorandum of Understanding for the SWAp*. This agreement can assume many different names and forms in individual cases. However, for the sake of simplicity, it will henceforth be referred to as the *Code of Conduct (CoC)*. **The Code of Conduct normally states the principles, rules and responsibilities of all actors that support the implementation**

of the sector programme. In that sense it can be seen as a way of operationalising and specifying the Paris Declaration in the sector context. This is also the reason why it is often the most important agreement guiding the principles for the implementation of the sector plan.

In order to have the intended impact (harmonisation and alignment of all actors in the sector in relation to national policy, planning and budgeting cycle), the CoC is ideally **introduced early in the process of developing a sector programme.** It is also important that this kind of document, if/when introduced, has a clear purpose and that its role in relation to other existing and planned documents is defined. It is normally logical and quite important to introduce the CoC before drafting a *Joint Financial Arrangement* (JFA) or MoU for a joint financing mechanism (see below).

Some examples of **issues that are often regulated in a Code of Conduct include:**

- The principle that all actors in the sector support the government's one and only policy, plan and expenditure programme for the sector;
- The principle of government ownership, and the subordination of all development partners to the joint SWAp regulative framework;
- A definition of the government's administrative focal point for external support to the sector plan and the roles of different ministry departments in the SWAp;
- Joint steering mechanisms and the meeting cycle for all actors in the SWAp based on, and taking into consideration, the government's regular planning cycle;
- Definition of where and how the poverty-related so-called cross-cutting issues should be aligned to the planning and budgeting cycle of the sector and government;
- Agreement on the introduction of different diagnoses and analyses (including the sector PFM assessment)
- Harmonisation and alignment principles such as decisions to:
 - avoid/abolish separate missions for evaluation, PFM assessment etc;
 - abolish and replace separate budgeting and reporting formats and mechanisms, PIUs etc, with jointly decided formats and cooperation under the sector's leadership in the regular administrative structures of the ministry/sector;
 - regulate how both the sector and its cooperation partners should contribute to the strengthening the capacity of the sector, including its PFM systems;
 - adapt the development partners' procedures and information requirements to the planning, budgeting and reporting cycle of the ministry/sector and of the MoF/government.

4.6.2 Memorandum of Understanding (MoU) /Joint Financial Arrangement (JFA)

The actors that agree to provide *financial* support to the sector in a joint manner, through a pooled fund, budget support or some other type of joint financing mechanism, normally agree on the conditions for this joint support in a specific *Joint Financial Arrangement* (JFA) or *Memorandum of Understanding* (MoU). The JFA/MoU development partners often represent a limited number of agencies in comparison to the entire group of external financiers that support the sector. For steering reasons, the **MoU/JFA should therefore**

ideally only regulate issues relating to this specific financing mechanism. All issues of concern to the *entire* development partner community should ideally be raised in the broader context where all or most of the actors in the sector participate, i.e. in a broader sector dialogue forum (which is often regulated by the CoC when such a document exists).

The negotiations on a JFA are normally lengthy, depending on the number and type of actors involved. It is essential that the proposal for the JFA is based on a ministry proposal which considers first and foremost the government's needs for information and alignment of procedures, linked to the deposit and transfer of funds.

You will find a variety of different JFAs/MoUs in the different countries and sectors with which Sida works. **The Nordic + group has designed a template for this kind of financial arrangement (n.b. not agreement since it is not a legally binding document).** This template comes with a guide for the process of negotiating the arrangement, and includes different standard alternatives under each headline, i.e. gives options regarding the degree of alignment with national systems of payments, reporting, procurement, audit etc.

The formulation of the JFA in the partner countries should normally, as far as possible, have the Nordic+ group's agreed JFA template as its point of departure. This document supports the process both by raising many of the important issues related to the content of PFM and other procedures, and by providing a transparent structure that facilitates keeping track of mutual commitments among the parties.

The MoU/JFA is a gentleman's agreement, meaning that it does not have legal status in itself. The legal matters are still dealt with in the bilateral agreements with each development partner. However, by referring to the MoU/JFA in the bilateral agreement and annexing it, the JFA/MoU can be given a different legal status.

The content of the JFA/MoU should include all relevant aspects relating to the financing mechanism such as:

- Conditions for timing of pledges
- Disbursement procedures and conditions
- Timing for meetings with the steering committee for the financing mechanism
- Accounting
- Procurement
- Audit and scrutiny
- Additional safeguards
- In cases where important aspects related to alignment and harmonisation in the sector are regulated in a CoC or equivalent, this needs to be taken into consideration when drafting the JFA/MoU, in order to avoid double regulation or inconsistency between guiding documents.

To support the *Paris Declaration*, the JFA/MoU should, to the greatest possible extent, refer to existing systems, procedures, manuals etc in the partner government, and only when absolutely necessary include safeguards/regulations or structures additional to the regular administration set-up.

4.7 PFM Capacity Development in the Sector

One of the main external determinants of the capacity of the sector ministries with regards to PFM is naturally the *Ministry of Finance* (MoF). Just as the finance administration department at the sector ministry should have facilitating service delivery in the sector as its main aim, the MoF should see that one of its most important roles is to facilitate service delivery by the sector ministries. However, this is not always the case, and for several reasons (capacity at both institutions etc), the decisions of the MoF are often made without sufficient consideration being given to the needs of the sector to efficiently manage its resources.

The trend of going “on systems” with donor resources, for example through budget support, has transparency and budget allocation consequences for the sector ministries. Instead of negotiating their resources directly with the development partners, it becomes increasingly important for the sector ministries to engage in a fruitful dialogue with the MoF regarding its overall resource allocations. **Some important aspects to consider regarding the relationship between the MoF and the sector ministries are the following:**

- The introduction/functioning of the MTEF (which is the guarantee of predictable and adequate medium-term allocation of funds for the implementation of the sector plan);
- Introduction/functioning of the government’s so-called IFMIS system in the sector (which defines most of the PFM, such as payments, accounting, reporting etc in the sector);
- Other matters related to budget execution, such as cash-flow management, the regulative framework guiding budget reallocations in-year, authority of budget holders, autonomy of the sector in handling PFM procedures and decisions etc.;
- Civil service reform-issues related to PFM: staffing (allocation, employment and deployment) and training of PFM personnel, payroll control and audit, restrictions regarding salaries or other types of expenditure etc.

Through its support to, and dialogue on, general PFM reform, Sida should encourage **an overall balance between the support given to the MoF and sector ministries concerned**, thereby enhancing a fruitful dialogue on balanced terms between these actors (not only in relation to the Sida contribution but also to overall reform initiatives and available funding for capacity development in the respective government organisations. On the one hand, the dialogue needs to encourage the MoF to consider the needs and requirements of the sector ministries. On the other hand, the sectors should be encouraged to play a more proactive role in relation to the MoF regarding PFM regulations, reform, and the creation of a fruitful working relationship.

The development partners should have a constant dialogue and constantly monitor the approach taken by the sector and the MoF to the design and roll-out of the IFMIS (IFMIS is a computer-based tool to facilitate efficient financial management, see chapter 7). Is it a top-down, or more of a dialogue approach? What kinds of information, support and communications are provided by the MoF for this process? Are responsibilities clearly defined in the respective ministry, and has the roll-out plan been discussed with the sector? Does the sector ministry take an active and informed role in the roll-out process, at both technical and political levels? Has the sector been

given an option in respect of when and how to join the process? What kind of financial and human resources are provided for this process? To what extent does the IFMIS system respond to the needs of the sector? To what extent has the sector been given the opportunity to influence the design and procedures in the IFMIS?

In the dialogue on PFM reform, at both the MoF and in the sector, development partners should include **the mandate of the sector in relation to the MoF**. Sometimes, the sector ministries have a stronger mandate, for instance concerning the reallocation of funds, than they are even aware of themselves. The development partners should, whenever deemed necessary, be ready to facilitate dialogue between the organisations and/or provide advisory support, to define what mandate the sector actually has, and to initiate a dialogue regarding possible changes in the mandate to enhance the sector's performance.

The capacity assessment of the sector should ideally **identify the dialogue forums that exist between the sector ministry and the MoF**. Is dialogue relevant to the sector budget process and to what extent are the representatives of the sector ministry prepared for the negotiations taking place there? The MoF should not only attend but also contribute in substance to these meetings. This is normally done by selecting a competent person with a clear mandate for this dialogue. (In many cases where sector ministries try to initiate a dialogue with the MoF, this has proven to be difficult).

These capacity aspects linked to the Ministry of Finance imply that the Sida programme officer must, directly or indirectly, be informed about these issues. It also implies that he/she needs to work closely with both his/her colleagues in the broader donor group in the sector in raising these issues, as well as with his/her colleagues at the embassy responsible for PFM and other key cross-cutting areas of public sector reform, and through this channel promote the inclusion of the sector perspective in these reforms. Finally, it may imply encouraging highly qualified support (in different forms) directly to the sector ministry to prepare for the dialogue with the MoF and other cross-cutting institutions.

4.8 Re-thinking Projects

Despite the benefits of giving programme support, situations may still exist where, for one reason or another (which then needs to be justified in relation to the *Paris Declaration* and Sida policy), it is more appropriate to provide support through a project modality. For instance, the possibility of supporting innovative projects, which are often financed through earmarked support, must not be excluded. Another example is large infrastructure projects, which are also likely to continue to be supported by earmarked funds.

Projects are, however, also dependent upon the public sector environment where they operate. A clear example of this is the recurrent cost implications of an investment. PFM issues should therefore not be neglected in the preparation of project support as they are often fundamental for adopting a position on the assessment criteria set out in *Sida at Work*. This is why all projects should be incorporated in the SWAp and made part of the sector plan.

Therefore, there is a need to assess the coherency of project support with the overall government policy and plans for the sector/area, which implies:

- Ensuring that the project is consistent with sector policy objectives;

- Aligning as many procedures as possible to national systems. Sida policies on PFM and aid effectiveness are also valid for project support;
- Providing full and timely information to government on project budgets and expenditures;
- Minimising transaction costs whenever possible, through coordination with government and other development partners;
- Including a clear road map towards better aligned and harmonised support in the future, and ensuring that reasons for choosing a project set-up are clear and justifiable;
- Never working through Project Implementation Units (meaning development partner-owned/controlled projects), but always through the regular structures of the sector ministry. However, these regular structures could include time-limited reform project units managed and owned by the sector (not to be confused with PIUs). However, PIUs (as defined in the Paris Declaration) are not consistent with the basic ideas of alignment to government structures.

Hence, the way of approaching a project contribution should not be fundamentally different from the approach taken to financing a sector programme through a joint basket or sector budget support financing arrangement. The introduction of new projects should always consider on-going sector programmes and be integrated with overall planning and budget procedures in the sector.

4.9 Recommendations

Below there is a brief list of recommendations regarding key PFM aspects to consider in the different phases of contribution management regarding sector programme support. To a great extent, these aspects are also valid in relation to project support.

- 1) Contribute to the understanding of the role of the different guiding documents for the SWAp (CoC and JFA/MoU respectively), and thereby ensure that each of the documents, and the documents in combination, in practice support the implementation of the Paris Declaration in the sector and the sector's ability to achieve results.
- 2) Both the CoC and the MoU should ideally align all procedures to the government's planning and budget cycle, including monitoring, evaluation and scrutiny (audit).
- 3) The sector-specific PER, PETS and other existing PFM analyses should be used as the basis for analysing PFM in the sector. Sida should refrain from introducing new PFM assessments in areas already studied. Often, a second opinion on analyses from multilateral organisations could be valuable.
- 4) Any capacity analysis/assessment of PFM should be done jointly with other development partners in the sector, in an integrated manner with other areas relevant to capacity development in the sector, and with a development perspective.
- 5) Promote financing modalities that are as aligned as much as possible in every given situation. The starting point should be the most aligned financial modality – non-earmarked budget support – and any deviation from this modality needs to be adequately justified in the assessment memorandum for the contribution.
- 6) Strive to ensure support for capacity development in both the MoF and the sector ministries regarding PFM reform. Furthermore, in its dialogue with the MoF, Sida

should bring forward the sector's perspective regarding PFM reform, and encourage the establishment of mechanisms for cross-ministry dialogue.

- 7) Support the sector in the regular budget process in relation to the MoF, monitor the allocations to the sector, and ensure that the systems developed by the MoF respond to the information needs of the sector.
- 8) Each annual meeting cycle between the development partners and the sector should include meetings with the MoF regarding specific PFM-related issues. The sector should also be given support (when necessary) to develop proposals for improvement of the budget, adequate programmatic structure, input to the IFMIS development etc.
- 9) Be prepared to fund, ideally jointly, TA and training activities for the sector to prepare, and be able to properly manage, the IFMIS system.
- 10) Strive towards the abolishment of certain input control mechanisms and focus more on output/outcome control, although this needs to be done gradually and with the backup of qualified TA to key PFM functions in the ministry.

5 PFM Assessment

This chapter provides an in-depth description of the main areas of PFM assessment and complements chapter 2, which outlines the approach for assessing PFM when preparing a cooperation strategy. The final section seeks to explain how conclusions can be drawn from the assessments and be applied strategically for the design of aid modalities and support to PFM reform. The chapter attempts to be generic and the issues put forward are applicable both when assessing PFM at the overall level and at the sector/decentralised level. Read more about the specifics of PFM in the sector and at the decentralised level in chapters 4 and 8 respectively.

In this chapter you can read about:

- **When to make a PFM Assessment and why;**
- **The Budget Analysis: why it is important and what to do when the budget structure is weak;**
- **What PFM diagnostic instruments you can use for different kinds of analyses;**
- **The PEFA Performance Measurement Framework: What it is, its pros and cons, and how to apply it;**
- **Procurement: Instruments to use and where to start;**
- **PFM Capacity and what issues to observe;**
- **The choice of financing modality in relation to the results of PFM diagnostic studies and how you can approach different kinds of weaknesses in PFM systems**

In almost all countries where Sida participates in government-to-government cooperation, some kinds of PFM assessments have already been made or are being made (the same goes for PFM reform programmes, see chapter 6).

5.1 Why PFM Assessment?

The reason for assessing PFM may differ.

Firstly, a PFM assessment may be an important development initiative to identify developmental constraints and build a foundation for central or sector PFM reform. The scope of such an assessment is considerable in terms of both resources and time. Furthermore, it requires that the PFM assessment is led by the partner government and that the process secures participation and ownership. If not, the possibilities of translating the assessment into a credible reform programme will be severely undermined.

Secondly, the PFM assessment may be made primarily to enable effective support. Sida's aim is to provide aid efficiently and effectively in line with the overall poverty reduction target through the use of the partner government's own public finance management processes and systems. This makes it necessary to assess both whether the budget allocations and policies applied are in line with these targets and whether the overall control processes and systems are reliable and able to implement the budget. The focus varies with the task, for example preparing a new cooperation strategy or a contribution to a sector programme. Although the reasons for assessing PFM may be different, in practice they overlap and complement each other and are distinguishable first and foremost by their level of ambition. What they have in common, however, is that they should preferably be made jointly with other partners, in a manner that supports ownership and further reform, and make use of available knowledge/diagnoses.

While the principle is to make use of available material, there are some important aspects that are often neglected. **Sida may therefore play an important role by supporting:**

- Capacity studies, as this critical issue often is neglected by existing PFM diagnostic instruments;
- Sector needs in terms of PFM systems, for example as regards management accounting;
- A poverty focus in PFM diagnostic and budget analysis through applying the perspectives of the poor on development and a rights perspective;
- A second opinion on existing studies that departs from different (less poverty-oriented) policy notions.

The PFM assessment is the process of drawing conclusions on the basis of diagnoses and other knowledge of the PFM system. In essence, it is about bringing knowledge of different elements of the system (covered by different diagnoses, studies etc) together in an integrated manner to enable questions to be answered. For example: Are the budget priorities reasonable in relation to policy? What are the main constraints to poverty reduction arising from weaknesses in the PFM system? What could a Swedish contribution possibly result in? What advantages and risks are there in using government systems as compared to using parallel systems and vice versa?

5.2 The Scope of Diagnostic Studies

The following table seeks to clarify how different aspects of PFM are covered in different reports and diagnoses. Read more about the different diagnostic tools in Appendix 3.²¹

²¹ A more detailed overview of diagnostic instruments is provided in "Assessing and Reforming Public Financial Management – A New Approach", Richard Allen, Salvatore Schiavo-Campo, Thomas Columkill Garrity, World Bank (2004).

Table 5.1

	Aspect to be assessed:	Main tools and sources:	Purpose:
Macro analysis	Macro balance, constraints and sustainability	IMF: PRGF, article IV reports WB: PRSC, CPIA, PER, Economic Memorandum; State: MTEF, PRS, PER, State Budget and Reports	To determine the macroeconomic balance in the country and the impact on public finance sustainability. Are domestic resources available to the country and growing? Is the budget in balance or financed by excessive and increased borrowing? The IMF reports give useful financial statistics, and also cover aspects of structural adjustment, which could be in conflict with poverty alleviation targets.
Budget analysis	To assess the “balance” of the budget and whether the budget is geared towards, and feasible for, poverty reduction	WB: PRSC, CPIA, PERs at central and sector level, PPERs – Participatory PERs give a greater in-depth analysis of certain aspects, PETS IMF: PRGF, Article IV reports, ROSC State: PRS, MTEF, budget documents and annual reports including PER.	To determine if the budget is balanced in a way that will make it possible to implement the PRS and whether the budget and outcomes reflect poverty reduction priorities. The value of the budget documents and annual reports depends on the quality and breakdown of information, often in-depth sector studies and development partner reviews are more useful. Studies of allocations within sectors are also relevant, where levels of service delivery, personnel and other resources should be considered.
	Gender and environmental aspects are considered in the expenditure policy	PERs, Special studies (gender budgeting), sometimes by NGOs. Benefit Incidence Analysis.	To reveal gender aspects of allocations and environmental impact. Analysis of types of infrastructure development, allocations to rural areas, water and sanitation, women’s participation in education etc.
	Budget composition	PERs, ROSC, IMF Article IV Reports, national budget documents and annual reports, PPERs – Participatory PERs give a greater in-depth analysis of certain aspects, individual sector studies, tracking surveys – (PETS), individual PFM studies	To investigate aspects of resource use in respect of central/local allocation, in relation to cost items such as salaries, the balance between investment and operational costs, regional and geographic patterns, etc.
PFM Systems analysis	PFM systems’ status, absolute and relative trend over the years	PEFA, PER, WB CPIA, CFAA, PPER, OECD-DAC new diagnostics ²² , HIPC-AAP, DFID’s FRA (Fiduciary Risk Assessment, see DFID How to note – Managing Fiduciary Risk when providing Budget Support)	To determine risk areas, development constraints and reform needs. Is procurement reliable? Is the budget comprehensive and implemented as intended? Is financial information available and reliable etc? PEFA is the most comprehensive and accepted tool, but other tools may provide more detail.

²² *Methodology for Assessment of National Procurement Systems*, draft June 2006.

		Aspect to be assessed: Main tools and sources:	Purpose:
PFM Systems analysis	PFM reform, components and status	Government Plans, PEFA, CFAA, PER, CPAR, DFID How to note – Managing Fiduciary Risk when providing Poverty Reduction Budget Support Annex 2, joint development partner appraisals	To study ongoing and planned reform efforts and determine credibility and realism. PEFA describes on-going and current reforms, it does not propose reforms. Study of government's reform programme. Do PFM reform efforts cover relevant weaknesses and areas? What progress has been made? Can the weak areas be expected to improve?
	Capacity to manage PFM systems and PFM reform	World Bank reports including their country strategies. DFID's FRA. See DFID's How to note – Managing Fiduciary Risk when providing Poverty Reduction Budget Support, chapter 7 in Sida's Manual for Capacity Dev (Oct 2005) See also chapters 2, 5 and 6 in this document.	To determine feasibility of support to reform efforts. Are there sufficient PFM staff and do they have the capacity to drive and implement reform efforts and improve the situation? What are the prospects for capacity building? No real structured diagnosis is available. Special investigations may be needed.
	Corruption	IGR, PEFA, CPAR, WB CPIA, Transparency International, DFID and OECD studies etc, U4 Utstein anti-corruption resource centre, see further chapter 6.7.	To determine the risk area of corruption. What is the general rating of the level of corruption in the country? In which areas? Also audit reports and court cases can provide useful information.
	Procurement	OECD-DAC ²³ , PEFA, CPAR, DFID's FRA, Nordic + groups Joint Procurement Policy (Nov 2004) and Sida's Procurement Guidelines (SPG 2004)	To determine if use of country procurement mechanisms is feasible and need for risk mitigation. Is procurement transparent and subject to fair competition? If not the use of other options will need to be investigated. The diagnosis may need to be further deepened by a study of practices and of corruption issues.

Several of these diagnostic instruments should also be used in studies of PFM status in the sector. A study of, for example, the feasibility of Swedish support to a certain sector may need to investigate the past, current and planned sector-specific levels of allocations in the total budget, whether it has additional parallel off-budget financing, and how secure the procurement procedures of the country can be expected to be. Sources of information could be the most recent state budget and outcome reports, the PER report, and the PEFA assessment. Of interest and importance could also be specific sector reports and an overall MTEF which provides longer-term sector plans. A more detailed presentation of sector PFM assessments is presented in chapter 4.

The selection of diagnostic instruments and reports and the emphasis to be made in the assessment differ depending of the purpose of the assessment, for example whether

²³ *Methodology for Assessment of National Procurement Systems*, draft June 2006.

a cooperation strategy is to be formulated and budget support proposed (see chapter 2), a SWAp (see chapter 4), or PFM reform support (see chapter 6) is being prepared.

It is recommended that **an initial study of a PER and the PEFA assessment report** is made to determine budget allocation patterns, the overall PFM system and its weaknesses, and on-going reform efforts. Such studies will give an overview of the main risk areas, of how well the different areas for the Sida assessment are covered, and indicate if and where further studies are needed. When further studies and analyses are needed, Sida should make use of the relevant available sources of information listed in the table above, including government documents.

There is also a need to find out about the **actual use of existing PFM systems and to what extent they are actually capable of providing intended services and goods funded through the state budget**, prior to any decisions on the profile and design of PFM reform. These kinds of analyses can be found in several of the diagnostic instruments mentioned, such as the PER or user surveys. It is crucial to find out the extent to which existing PFM systems are actually working and what can be done to improve them instead of replacing them.

There could also be major weaknesses in systems affecting the PFM systems and processes that do not fall under the PFM institutions' mandate and jurisdiction. Examples of such areas can be civil service regulations affecting PFM staff in government institutions. In such cases it may also be relevant to **study on-going civil service and public sector reform efforts** as well as other reform areas that influence PFM systems and institutions.

5.3 Budget Analysis

A short operational guide to budget analysis, including the questions to pose, is presented in chapter 2. This section complements that guide by providing more information on the background of the different issues and gives additional advice on what to think of when analysing budget documents and how to handle weaknesses.

It should be possible to make an analysis of the allocations made in the budget document/s from the documents and assessment tools mentioned in the table above. A budget analysis investigates a number of different aspects. The most comprehensive analysis is normally provided through the *World Bank Public Expenditure Reviews* (PERs). The budget analysis relates to macroeconomic analysis, which is not covered in this material.

The analysis of the budget is intended to provide answers to some basic questions that will make it possible to assess the ability of the state budget to transform budget resources into poverty reduction. Is the ambition of the government's PRS realistic? Is the budget reasonably balanced between different kinds of expenditure and between different levels? In summary: is the budget a reasonably adequate instrument for achieving poverty reduction?

5.3.1 Some General Issues to Consider when Analysing Budgets

All budget resources should ideally be known when analysing the budget. In many countries they are not, hence **budget comprehensiveness** is a problem. Off-budget resources can be substantial and are often a result of weak PFM systems. Examples of such resources are fees raised at the local level, for example at hospitals or schools, and

development partner-funded activities. The latter could be resources provided in-country through separate accounts, donations of, for example, medicines and school books in kind, technical assistance paid overseas etc. Such flows could be significant. Special studies at service delivery level and questionnaires to development partners may give a picture of the extent and direction of these resources.

Assessing the allocation pattern may be difficult because of differences between countries in services and expectations on the public sector. What, in some countries, is regarded as a natural ingredient in the public sector's service envelope is, in other countries, provided by the private sector or through the family sphere. Examples of differences are costs for childcare, care of the elderly, costs for medical care and pensions, which in some countries are mainly funded by private insurance. This means that it is difficult to determine – by merely using the share of GDP and the public budget – whether a fair portion of the budget is allocated to support the poor, and if the public contribution to the budget through the tax effort is reasonable. More in-depth analysis and comparisons between similar countries or in regions could be more appropriate than global standards and comparisons.

A study of the budget documents may still not reveal the real allocation pattern, as **the difference between the budget and the actual outcome at the end of the year – the budget variance – may be large.** In such cases a study of the annual financial statement (i.e. a consolidated report on revenue and expenditure) may give a clearer picture of actual resource allocation. There could be several reasons for such deviations, for example that:

- annual budget preparation is weak and fails to recognise already committed costs which are consequently missed in budget preparation;
- arrears are rolled over to the next year without being included in the budget;
- revenue forecasts are overestimated, resulting in reduced expenditure budgets or cash release restrictions by the treasury;
- poor predictability of donor funding or failure to meet conditionality;
- capacity constraints limiting the absorption of funds in sectors;
- natural disasters and other exogenous shocks necessitating re-prioritisation.

In particular the capital budget and development partner-financed investments may have a low level of implementation due to capacity constraints. Late disbursements of funding, often by development partners, and poor predictability of available funds lead to delays and implementation problems and underutilisation of resources as compared to the budget.

5.3.2 The Link between Budget Allocations, and Policies

There are a number of PFM instruments and processes that will transform the political intentions and the political priorities to corresponding allocations of resources in the annual state budget. **The following aspects need to be considered in the analysis:**

- The PRS should contain a clear description of priority areas and how they correspond to poverty alleviation. Priorities cannot only be defined as certain sectors. Also within social sectors you will find areas with limited poverty impact. Development results often presuppose inter-sectoral allocations, for instance funds for

roads in rural areas and resources to invest in new schools. The allocation of public expenditures needs to take into account the poverty situation as well as the scope for pro-poor structural reforms, the mobility of the labour force, and the overall flexibility of the economy. Trying to define individual “poverty expenditure” beforehand is often difficult. Target groups could have different opinions than development partners on the areas that should be given priority. Individual, country-based conditions, also in social sectors, should always be considered and it could be more efficient to introduce follow-up mechanisms on actual disbursements and poverty results.

- The same priorities that come out of the PRS, preferably in the same structure, should be reflected in the MTEF, with a price tag on each expenditure area. Calculations in the PRS and the MTEF need to be based on the same statistics and financial data.
- The overall resource envelope for the MTEF should be derived from an operating macroeconomic projection model, which is able to calculate financial resources available for public expenditure in different scenarios. Allocations to different expenditure areas could be restricted due to macroeconomic conditions agreed between the Government and the IMF. This could limit the possibilities of increasing the salary part of the budget or the investment volume. This makes it important to discuss macroeconomic conditions and poverty-oriented expenditure programmes at the same time.
- The first year of the MTEF should represent the government’s proposal for the following year’s annual state budget. Calculations must be derived from the same databases. Sector MTEFs should be consistent with sector plans and the overall MTEF resource envelope.
- The annual budget must be trustworthy as a management tool once parliament has approved its allocations between different expenditure areas. It should not be possible to modify main allocations without new parliamentary decisions.
- It is important that all of these instruments – the PRS, the NDP, the MTEF and the annual budget – are recognised by all legal parties. This implies that all of them should be publicly debated and approved by parliament.

Before weaknesses in individual parts of the process are identified and recommendations made on how to deal with them, the first question that should be asked is whether it will be possible to implement the PRS at the overall level. Are the ambitions expressed in the PRS feasible considering different kinds of constraints? In some cases, the PRS is an externally-driven product, reflecting more the ambitions of development partners than realistic assessments of the government. In other cases, it becomes a political list of wishes, without corresponding very much to financial realities on the ground and to already committed costs for salaries etc. This may be further enforced by the organisational split that often exists between a ministry of planning responsible for preparation of the PRS and the MoF’s budget department that prepares the annual budget.

- Are the projections and data in the PRS reliable? Are sources of data reliable?
- Are there financial resources to fund the PRS? Not only as pledges from development partners but as hard commitments at least for the next few years? Are they reflected in the MTEF and are they traceable?
- Is there domestic capacity to absorb the resources anticipated for the PRS?

5.3.3 Balanced Composition between Different Expenditures and Levels

In many countries there are two budgets – one **capital or development budget** including major investments and/or external support, and one **recurrent or operational budget** containing government’s annual funding of day-to-day operations.

Expenditures should be balanced between recurrent and investment costs.

Investment budgets are often financed through external contributions and no calculations of recurrent cost implications of the new investment are made. This weakness could also be the result of separate structures for the responsibility for the recurrent budget (often with the MoF) and for the investment budget (with the planning ministry or corresponding administration). It is especially important in sector programmes to check on the balance between recurrent and investment allocations. There are many restrictions linked to this, not least as development partner funding of recurrent costs may be classified as capital expenditures, and investment resources in the budget are often under-consumed due to poor procurement planning and cumbersome procedures.

Another important balance in the budget is between salaries and allocations for other recurrent expenditures needed to finance operations such as teaching in schools or health services (books, medical equipment, maintenance of buildings etc). This can be a major problem for efficient service delivery. In some countries, the available budget resources can only finance salaries. This makes external contributions to the budget important, which often represents the difference between service provision or not. Imbalances between allocations to salaries and other recurrent expenditures are an issue that also needs to be discussed at the macro level. A permanent imbalance needs to be handled in a public sector reform process, based on analyses of the necessary and feasible size of the public sector. At the macro level, the IMF is also likely to present opinions on the size of salary expenditures. This is an issue that should already be brought up for discussion at the formulation stages of the PRS; meeting some of the millennium goals may require expansion of front-line staff in education and health.

In countries where **the capital budget** is designed to contain all external funding, it **may include substantial elements relating to recurrent costs**, for example financing medicines and schoolbooks. Therefore, a detailed study of existing budget documents is essential. The introduction of the standardised GFS (*Government Financial Statistics* – IMF) classification of both the capital and recurrent budget should ensure that investments and recurrent costs are clearly revealed in whatever budget document they occur.

Yet another important balance is the allocation of budget resources between different institutions at central level and between central and local level. It is often the case that the MoF and other centrally placed institutions receive a disproportional part of the budget compared to line ministries. The MoF could be responsible not only for its own administration and systems, but also for resources to be transferred to local government and resources (credits) from development partners. Too many resources in the hands of the MoF often reflect imbalances in power-sharing with line ministries.

As a result of close relations to the political level, in many of the countries concerned there is also an imbalance in the allocation of resources between the central and local administration. A disproportional part of the budget could be spent on administration staff at central level at the cost of local service provision. In countries where local authorities are autonomous (Uganda, Ethiopia, Honduras) their position is stronger, especially if state budget transfers to the local level are protected through legislation.

A closer study of the budget documents would normally reveal if there is an imbalance in resources allocated to central and local level.

Geographic or spatial allocation patterns can also be analysed and may be very relevant for determining the poverty orientation of the budget. This would, however, normally require special analysis and compilation of data.

5.3.4 Sustainability and Vulnerability

The issue of sustainability and vulnerability pertains to both the revenue and the expenditure side and, in particular, to the relationship between the two.²⁴

On the **revenue side**, a distinction needs to be made between:

- recurrent incomes in the form of taxes and levies;
- discretionary incomes, i.e. proceeds from privatisation;
- predictability and trustworthiness of external grants and loans, and;
- domestic borrowing. Such a breakdown will yield a picture of the predictability and sustainability of the public revenues.

To this should be linked a breakdown of the **expenditures side** into:

- recurrent expenditures that are fixed in the short to medium term;
- investment or capital expenditures of a more discretionary nature, and;
- an analysis of the public debt and other government liabilities.

The combined picture of the analysis of these aspects will yield a rough and ready assessment of **the sustainability of the budget and vulnerability in terms of exposure to factors beyond the direct control of the government**. Among the more important aspects are:

- the magnitude and trend of budget deficits and their source of funding;
- the share of recurrent expenditures covered by continuous and predictable sources of income, for example regular tax collection;
- dependence on external funding (ODA), totally and for current and capital expenditures, and with a distinction made between grants and loans;
- the magnitude and timing of financial commitments (debt service, pensions, etc.).

The analysis corresponds in parts to the information contained in the **government balance sheet**, which should be consulted (if there is one). How large are the government's financial assets in relation to short-term and long-term liabilities? Are all liabilities known, for example subsidies to and debts in state-owned enterprises or pension debts?

An analysis would also need to consider whether, at the macro level, the budget represents a reasonable share of GDP. Economies in developing countries cannot carry budgets representing more than a certain share of GDP, for macroeconomic reasons and in order to avoid increasing national debt. As a rule of thumb, revenue as a percentage of GDP may correspond to 15–25% in developing countries.

²⁴ *Integrated Economic Analysis for Pro-Poor Growth*, Sida (2006).

Summary of advice on budget analysis:

- study existing budget documents and the balance of the budget
- investigate the extent of off-budget resources
- study whether the allocations are in line with policy and plans
- pay special attention to shifts in allocations
- do not rely solely on the budget – study the outcome as well
- study the distribution of resources between central and service delivery levels and between different cost items (salaries, equipment, maintenance etc)
- sometimes an in-depth study of decentralised regional allocations and/or transfers is necessary
- study outcome reports of existing budgets related to programmatic, functional, economic, spatial and administrative dimensions.

Possible measures to address identified weaknesses

1. When there are no priorities or responsibilities identified in the PRS
 - Initiate a dialogue on this issue together with other development partners
 - Support capacity development in planning functions
 - Focus on how the MTEF can prioritise between different areas in the PRS
 - Initiate a dialogue on how sector plans are reflected in the PRS and, vice versa, how sector plans can affect the PRS/MTEF
2. When the MTEF does not reflect the poverty priorities reflected in the PRS
 - If possible avoid the situation by supporting an integrated process of defining the PRS and the MTEF
 - Bring up the issue in the dialogue
 - Support reform and capacity development for the MTEF
 - Support the development of costed sector plans
3. When the formulation of the annual budget is disconnected from the MTEF
 - Bring up the issue in the MTEF process and support reforms that aim at making the first year of the MTEF represent the fiscal frame of the annual budget
 - Support capacity development in budgeting
4. When the budget composition is not feasible in relation to a realistic poverty programme
 - Use recommendations from PERs etc as proposals to the government
 - Support the development of PRS, sector plans and budgets, which considers an appropriate cost mix and balance
 - Support capacity for planning and budgeting
5. When the budget presentation is non-transparent making budget analysis difficult
 - Support the introducing of standard classification (GFS, COFOG) including functional and programmatic classification
 - Support Public Expenditure Reviews at central and sector level
 - Support Public Expenditure Tracking Surveys
 - Support reform of the budget presentation

5.3.5 Possible Measures to Address Identified Weaknesses

More often than not, the analyses described above reveal weaknesses in the budget and in the budget processes. The box above lists possible measures to address identified weaknesses.

5.4 Assessment of PFM Systems

5.4.1 PEFA

The PEFA tool – (Public Expenditure and Financial Accountability)

The PEFA performance measurement framework (PEFA PMF) is one of three elements of the strengthened approach to support PFM reform agreed by development partners in the OECD DAC cooperation group.²⁵ It focuses on the performance of the technical PFM systems (budgeting, accounting, payment, procurement, revenue and audit) and **not** on the budget allocation pattern, poverty reduction results or the performance of the economy.

PEFA covers most of the PFM system components described in part 4, but is structured in relation to the following critical dimensions of performance of an open and orderly PFM system:

1. **Credibility of the budget** – The budget is realistic and is implemented as intended
2. **Comprehensiveness and transparency** – The budget and the fiscal risk oversight are comprehensive, and fiscal and budget information is accessible to the public
3. **Policy-based budgeting** – The budget system enables the budget to be prepared with due regard to government policy
4. **Predictability and control in budget execution** – The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds
5. **Accounting, recording and reporting** – Adequate records and information are produced, maintained and disseminated to meet decision-making controls, management and reporting purposes
6. **External scrutiny and audit** – Arrangements for scrutiny of public finances and follow up of the executive are in place and operating

31 performance indicators or benchmarks have been defined, many of them with a number of sub-dimensions. In the assessment, each indicator or benchmark is given a score from A to D in which A indicates a score meeting high standards on an international scale, while a D is a residual score below a certain minimum standard, also this on an international scale and not necessarily in relation to the specific situation and circumstances in developing countries. For each score level, a detailed instruction is given in the PEFA guide. The guide and further tools, for example a checklist for terms of reference, questions and answers, are provided at www.pefa.org.

²⁵ The three components are: 1) a country-led PFM reform strategy and action plan, 2) a coordinated donor-integrated, multi-year programme of PFM work that supports and is aligned with the Government's PFM reform strategy, and 3) a shared information pool. The PEFA framework is a tool for achieving the third component. www.pefa.org

Table 5.1 The PFM High-Level Performance Indicator Set, Overview of the indicator set

The following example is from a PEFA performance measurement report made in 2006.

Indicator	Brief explanation	Rating
Budget Credibility		
1. Aggregate expenditure outturn compared to original approved budget	Deviation of actual expenditure from the approved budget has been greater than 15% in two of the last three fiscal years	D
2. Composition of expenditure outturn compared to original approved budget	The variance in expenditure composition exceeded the overall deviation in primary expenditure by less than 5 percentage points in each of the last three fiscal years	A
3. Aggregate revenue outturn compared to original approved budget	Actual domestic revenue collection has been equal to or greater than 97% of budgeted revenue collection in two of the last three fiscal years. The continued practice of offsets is of concern.	A
4. Stock and monitoring of expenditure payment arrears	There is no system for monitoring expenditure arrears and therefore no reliable and complete record of the total stock of arrears. Some specific types of arrears are monitored and have been reduced to zero under the IMF's PRGF programme.	D
Transparency and Comprehensiveness		
5. Classification of the budget	Budget includes administrative, economic, and functional classification of expenditures. The use of a number of different classification systems currently impedes consolidation of the budget.	C
6. Comprehensiveness of information included in budget documentation	The 2005 budget documentation satisfies 5 of the requirements for information of the 9 listed by PEFA.	B
7. Extent of unreported government operations including those funded by donors.	The comprehensiveness of fiscal information has improved in recent years. The extent of unreported government operations is estimated to be in excess of 10% of total expenditure. Unable to score due to lack of overall information.	Could Not Score
8. Transparency of Intergovernmental Fiscal Relations	The distribution of revenue and expenditure responsibilities between different levels is not fully transparent and unpredictable in its application. Central government reporting of local government expenditure is comprehensive. The intergovernmental fiscal system is currently being reviewed.	C+
9. Oversight of aggregate fiscal risk from other public sector entities	Oversight of fiscal risk has improved in recent years but the nature of the government's liabilities in the SOE sector is not routinely monitored. Sub-national monitoring by the centre is in place.	D+
10. Public access to key fiscal information	The government makes information available to the public on 2 of the 9 listed types of information.	C
Policy-based Budgeting		
11. Orderliness and participation in the annual budget process	A clear budget calendar exists but it does not allow sufficient time for either the MTBF or annual budget process. Parliament approves the budget before the start of the fiscal year. However, policy-makers get involved in budget formulation only at quite a late stage.	B

Indicator	Brief explanation	Rating
12. Multi-year perspective in fiscal planning, expenditure policy and budgeting	Some basic elements of a MTBF process have been introduced. Further developments are required to improve the quality of the MTBF and enhance its linkage with the annual budget.	D+
Predictability and Control in Budget execution		
13. Transparency of taxpayer obligations and liabilities	Legislation and procedures are clear but tax authorities still have substantial discretionary powers. Reforms are underway to address some of these issues.	C
14. Effectiveness of measures for taxpayer registration and tax assessment	<i>Self-scoring by State Tax Inspectorate:</i> Dimension (i) B; Dimension (ii) C; Dimension (iii) C. Further information required to independently verify performance.	Could Not Score
15. Effectiveness in collection of tax payments	The debt collection ratio for the last two fiscal years was 84%. Revenue collection procedures are adequate from an accounting control perspective.	B+
16. Effectiveness of cash flow planning, management and monitoring.	There is an absence of sound cash planning and management. The government has introduced measures aimed at addressing this issue but still has a considerable distance to go in making it effective.	D
17 Recording and management of cash balances, debt and guarantees.	There have been significant improvements in the handling of public debt but there is still a weakness in the consolidation of government's bank accounts.	B+
18. Effectiveness of payroll controls	The process is decentralised and personnel and payroll functions are carried out by the line ministries' accounting units. This has facilitated informal adjustments to approved establishment and salary levels and demonstrates a lack of effective control. Unable to score due to lack of overall information.	Could Not Score
19. Competition, value for money and controls in procurement	The legislative framework is satisfactory but still has to become fully effective in practice. There are notable weaknesses in the use of offsets and the lack of appeal in the complaints process.	C+
20. Effectiveness of internal controls.	Internal control is ineffective in practice and not supported by the legal and regulatory framework or by recent reforms.	D+
21. Effectiveness of internal audit	There is no effective internal audit function.	D
Accounting, Recording and Reporting		
22. Timeliness and regularity of accounts reconciliation	Unable to score due to lack of overall information on suspense and advance accounts	Could Not Score
23. Availability of information on resources received by service delivery units	No comprehensive data collection has been undertaken in the last three years. There are weaknesses in the capacity of the accounting and classification systems to report financial resources transferred accurately.	D

Indicator	Brief explanation	Rating
24. Timeliness, quality and dissemination of in-year budget execution reports.	In-year reports on budget execution are generated on a regular and timely basis. The reports are not comprehensive and are not compatible with budget estimates. The quality of the information is compromised by the manually based system and various other practices. The reports are designed for control purposes and are not used to provide useful management information to the line ministries.	C+
25. Timeliness of the presentation of audited financial statements to the legislature.	Financial statements are not submitted, only statements of aggregated cash transactions measured against budget lines.	D
External Scrutiny and Audit		
26. The scope, nature and follow up of external audit reports.	Effectiveness of external audit is handicapped by its emphasis on its compliance and policing function rather than that of assessment.	D
27. Legislative scrutiny of the annual budget law	There are active committees but their ability to function effectively is compromised by lack of capacity and the practice of ex post facto approval of expenditure.	D+
28. Legislative scrutiny of external audit reports.	While committees are in existence and active, there are restraints which restrict the capacity of Parliament to review critically audit reports. The authorities of Parliament for reviewing the audit report need to be clarified.	D
Donor Practices		
D1 Predictability of Direct Budget Support.	Forecasts are not provided but only one year fell short of that budgeted for	C+
D2 Financial Information provided by donors for budgeting and reporting on project and programme aid	There is insufficient data to score this indicator	Could Not Score
D3 Proportion of aid that is managed by use of national procedures	Donors' own procedures are the norm. There is insufficient data to score this indicator	Could Not Score

An assessment exercise leads to a PEFA-PR – *Performance Report* that, in addition to the assessment and scores, shall include a summary and introduction, country-related information, and a section presenting any on-going reform processes in the field of PFM.

In essence, the developed PEFA PFM *Performance Measurement Framework* is intended for use by a group of development partners and a country wishing to assess its PFM standards and development. Through continuous use, the framework can also be used to determine progress in the PFM reform work. The assessment is intended to be carried out by an external assessment team. It should be undertaken at the request of a partner government and development partners. The external assessment is recommended to take place at an interval of around three years. Self-assessment by the government concerned is also recommended on an annual basis.

The focus of the indicators is on PFM at central government level, including the relevant oversight institutions. Operations of other levels of general government and of public enterprises are considered only to the extent they impact on the national PFM

system and its linkages to national fiscal policy. Just like the *Public Expenditure Reviews*, however, nothing prevents a sector ministry from using many of the indicators to assess its own PFM system and performance.

Other diagnostic and analytical tools are still used in parallel and as a complement to the PEFA assessments. The CFAA analyses by the *World Bank* have largely been replaced by the PEFA assessment.

5.4.2 Advantages and Limitations of the PEFA Analysis

Some of the good reasons for a PEFA analysis are that it:

- provides a set of international benchmarks for overall PFM performance that can be accepted by all parties, alleviating the need for individual analyses by each party
- covers most components of PFM
- identifies major weakness and strengths
- provides an external assessment, making use of experience from other countries
- can be used to identify risks and distinguish between risk mitigation needs
- can be an input for further in-depth analysis and reform planning
- can be used to measure progress and to establish a baseline.

Risks in relation to a PEFA assessment could be:

- if it is taken as a reform plan without further in-depth analysis of the underlying causes of poor PFM performance, there is a risk that reforms will be misdirected
- the indicators do not provide any basis for reform sequencing or setting priorities
- the framework does not weigh the benchmarks in terms of importance. There is a risk that reform concentrates on quick gains and benchmarks which are easily improved upon
- since benchmarks cannot be weighted, it is not very useful to compare country average scores
- the benchmarks do not always identify when progress has been made. There can be gross improvements while the rating remains a D. Considerable efforts may be needed to progress from a D to a C
- the indicators are based on rather advanced “best practices”, which may be very far from where the country in question is at present, and the targets may not be universally accepted
- the focus is explicitly on the system, hence underlying causes may not be covered such as the capacity of financial managers and staff
- an expert-led critical assessment may not create the necessary ownership and understanding of the need for reform efforts
- a PEFA assessment focuses on the technical system and its performance – not on service delivery or the budget allocation pattern (this is the area of a PER)
- The PEFA assessment focuses on central government although it may, in parts, be used for diagnoses of sector systems or decentralised levels. This limits the possibility of assessing the functioning of the PFM systems in relation to service delivery through the instrument.

Some of the risks presented above make it clear that **the PEFA framework alone is rather unsuitable as a basis for general conclusions on foreign aid or loans.**

Conditions given by development partners sometimes include the requirement that a certain number of benchmarks related to the PEFA analysis should be met annually. This has the disadvantage of leading to the quick fixes or “easy” benchmarks in the analysis being given priority. A sole focus on benchmarks may also draw attention from other aspects that are not covered but are equally or more important, such as capacity, general service conditions and management issues.

Although a PEFA assessment in isolation does not give a sufficient picture for many decisions, **it is a very useful tool to identify PFM system weaknesses and to obtain a basis for further PFM reform efforts and improvements.** Without a functional PFM system, the entire resource allocation and implementation of the public agenda is at risk.

For the above reasons, it is important that a PEFA assessment and subsequent processes are properly designed. It is important to **design the process to involve and engage the partner country**, to provide scope for additional analysis and discussion once the results are out, to make priorities and sequence reform efforts, and to include capacity development measures, for example training, workshops and conferences, and to promote widespread understanding and consensus regarding findings to facilitate reform planning. As discussed in chapter 2 above, a PFM assessment must also be put in relation to the country-specific development objectives when it is used as an input to a PFM reform programme. This necessitates knowledge/study of the factual situation in terms of service delivery and asking what matters most for the poor by using the two perspectives in the *Policy for Global Development*.²⁶

5.4.3 The PEFA Assessment Process

For a successful PEFA assessment and subsequent reform process in terms of country ownership and commitment, it is important how the assessment of the PFM systems is conducted. A possible step-by-step illustration of the process could be:

1. When the proposal for a PEFA assessment emerges, it is important to explain and discuss purpose, content and process between lead development partners and government representatives, including representatives of the MoF and some main line ministries and the political leadership. Distribute the guidelines and assessment reports from other countries. It is important from the outset to clarify that engagement in a PEFA assessment is a joint undertaking with a one-to-one relationship between government and development partners – although the assessment is often performed by external experts engaged for the purpose.
2. The timetable needs to be mutually agreed. Ensure that the assessment process fits well into the government’s timetable and that enough time is given for participation.
3. If English is not commonly spoken, a translation of the assessment guidelines will be necessary. Some translations have already been made, for example into Russian. These can be accessed through the PEFA secretariat.
4. Carrying out a PEFA assessment requires striking a balance between the need for an independent validation through the use of external experts and ensuring ownership by the government, which is a necessity for it to be a basis for reform.

²⁶ Poor peoples’ perspectives on development and a rights perspective.

5. The advantages and necessity of conducting the assessment with the assistance of qualified TA support must be explained, as well as the work burden and time required to make a fully understandable and properly owned assessment. Resources/donors for the assessment need to be identified as well as a suitable time period and consultants. The minimum for a team of three to four consultants to carry out an assessment is said to be three weeks. Depending on the pedagogic ambitions, capacity of the recipient, availability of data, and complexity of the PFM and institutional set-up, more time may be required. Often validation of findings is problematic and time-consuming.
6. From the above, it follows that quality assurance mechanisms/arrangements should be discussed and decided upon from the very outset. The PEFA secretariat has limited possibilities of taking on this role, although they may be consulted. It is very important that the data on which the scoring is based is disclosed to permit quality assurance and ensure high levels of credibility.
7. ToR for the exercise, for TAs and participating units and managers need to be drafted and agreed. The ToRs should include initial training in the assessment tool and the type of material the government would need to provide, as well as responsibilities and time frames for development partners, consultants and government. A full briefing and discussion on assessment results should be included.
8. Then follows the preparatory phase when consultants study earlier assessments and the country context and specify information requirements for the forthcoming assessment. They should give government guidance on data to be gathered and presented for the assessment and sufficient time to prepare such data.
9. The government prepares the requested reports and information. This may require some time and data collection.
10. Consultants study the information and prepare and present a draft assessment with background data and rationale. This involves the scrutiny of the 31 benchmarks and around 60 sub-dimensions.
11. Sessions for feedback and further discussion of results are organised and the final report prepared. It is important to allow dialogue and discussion of the draft findings while the consultants are in place, for learning purposes and in order to clear up misunderstandings and reach agreement.
12. To allow reasonable time for digestion of feedback and interaction, normally two missions by the external assessors will be needed
13. Final debriefing, publication and distribution of the report. It should be agreed in advance that:
 - the report is to be presented as a joint assessment of development partners and government. In case of disagreement, the report would be presented by development partners with a commentary appendix from government. However, in principle, the benchmarks should be objectively assessable and the guidelines for ratings sufficiently clear.
 - the report should become public after completion and be made available to anyone that requests the information.

The PEFA process does not end with the diagnosis – it is most likely the first step of a PFM reform process, which is further described in the next chapter.

It will also form part of the assessment of risks and strategic choices related to development cooperation as described further in part 5.5 and chapter 2.

5.4.4 Diagnosis of On-going and Planned PFM Reform

To determine future risk, it will also be necessary to assess if the government has a credible programme to improve the standard of the PFM systems. In its *How to Note Managing Fiduciary Risks* when providing *Poverty Reduction Budget Support*, DFID presents relevant questions to assess whether the programme is government-led, realistic and achievable, integrated and efficiently sequenced, relevant and sustainable, builds demand for change, and is linked to specific performance indicators.²⁷ The analysis might well necessitate scrutiny of a number of different and development partner-supported initiatives from these different aspects (cf also chapter 2).

The mapping of on-going reform initiatives should be able to use the PEFA assessment report as its point of departure. In addition, forthcoming planned initiatives may need to be added. It is of critical importance not to overlook the capacity issue – further discussed below – when assessing PFM reform. If the reforms are directly derived from diagnoses of the technical system, this aspect may be overlooked, although the reasons for identified weaknesses may be due, for example, to the organisational set-up. Such capacity issues may also impede technical reform efforts.

Chapter 6 deals with the design of PFM reform efforts and how the PEFA assessment can lead further towards a well-defined reform programme.

5.4.5 Diagnosis of PFM Capacity

To determine the feasibility of PFM reform efforts and the pace at which they may take place, it is necessary to obtain a picture of the relevance of the organisation of the government administration. It is equally important to obtain a picture of the number of staff and their qualifications and experience.

Sida defines capacity as conditions that must be in place for development to take place.²⁸ It is an overall concept which covers conditions at individual as well as at organisational and institutional levels. The PEFA assessment measures performance of key indicators of the PFM system but not the factors that impact on the performance such as the competence of the staff and whether the organisation is relevant for its task. Therefore, it is necessary to supplement the PEFA assessment with an assessment of capacities which impact on the ability of the system to perform.

5.4.6 Capacity Elements to Assess

A. Resources are the basic types of capacity that impact on organisational performance. Resources include quantity and quality of staff, financial resources and availability of facilities, technical infrastructure such as telecommunications, IT usage, equipment and transport. Chapter 6 provides an overview of the types of PFM staff whose adequacy in terms of numbers and skills/experience need to be assessed.

²⁷ *Managing Fiduciary Risk when providing Poverty Reduction Budget Support, How to Note*, DFID (2005).

²⁸ *Sida's Policy for Capacity Development*, Sida (2001).

B. Management capacity may be divided into strategic leadership, operations management and change management. Strategic leadership is the capacity to assess and interpret needs and opportunities outside the organisation, to establish direction, to influence and align others towards a common aim. Without strategic leadership at the political level, comprehensive PFM reforms are less likely to succeed. Operations management concerns the direct production of outputs as well as continuous improvement of operations. It also includes a strong element of human resource management. Change management is concerned with improving services by developing systems and organisations and includes the capacity to plan and manage a PFM reform programme.

C. Institutional framework: In performing their missions, individuals and organisations operate within institutional frameworks of rules, procedures and organisational cultures that may either promote or hinder desired performance. Hence, an assessment of the institutional framework also needs to be included in a capacity assessment.

The institutional framework consists of:

1. The **regulatory framework** for PFM that:
 - defines the mandates, roles and responsibilities of key actors in the PFM system;
 - specifies the rules and procedures for budgets, financial management and procurement.
2. Other **crosscutting institutions** such as:
 - rules and procedures for organisational reforms such as creating, dividing, merging and closing organisational entities;
 - rules and procedures for personnel management such as staffing rules, service schemes, recruitment, promotion, transfer and lay off of staff;
 - salary systems and special bonus or topping up systems.
3. **Organisational cultural features** and informal behaviour norms such as the degree of competition, cooperation and information-sharing between and within organisational entities, and also corrupt practices and behaviour.

D. Support structures for developing PFM capacities include education and training facilities run by government, the MoF, universities or private institutions that produce PFM professionals at different levels and which can be utilised for maintaining and upgrading skills of existing PFM staff. The supply of consulting capacity in PFM, management development programmes and IT also needs to be assessed, as well as the extent to which technical assistance personnel are used to operate and develop the PFM system.

Guiding questions for analysis and assessment of capacity

The actual status of the capacity of the system may be mapped and described by answering the following set of questions:

- What capacity, in terms of human resources, is available to manage the existing system? Is there a sufficient number of qualified technical staff in the various PFM areas, organisations and units at different levels? Are the daily operations led by competent managers? What are the main capacity constraints?
- Is the existing regulatory framework of the PFM system generally known and adhered to? Are regulations, handbooks and instructions up-to-date and readily available to staff?
- What capacity is there to lead and manage a PFM reform programme? Are there staff and managers in key organisational units with knowledge and experience of leading development programmes and projects? Are there adequate incentives for managers and staff to engage in reform work?
- What institutions govern human resource management in the PFM field? (Staffing rules and procedures, service schemes, recruitment, promotion and remuneration systems. Degree of autonomy of PFM organisations to manage human resources.) What are the main constraints to PFM reform?
- What institutions govern organisational restructuring? Powers and procedures to decide on the restructuring of an organisation, including reducing and/or reshuffling staff. What are the main constraints to PFM reform in the current organisation and the division of responsibilities between different government ministries and institutions?
- What capacity is there to attract, train and retain professional staff in the PFM field? An analysis should be made of the system the country has in place for the education and training of PFM professionals and managers.
- Formal qualifications in terms of degrees, diplomas and certificates may be obtained in the general education system, through private institutions, and through state-run institutes for pre-service and in-service training. What capacity exists to produce qualified individuals? To what extent does the system meet the needs, in terms of quality and quantity, of the PFM system?
- What capacity is there for in-service training of PFM managers at various levels (central, regional, local) and according to the hierarchy (heads of sections, divisions, departments)? Are there ongoing development partner-supported programmes for training PFM staff?
- Do the organisations concerned have any systematic plan in place for the development of the professional skills of their professional and managerial staff?

Country assessment reports referred to in section 5.1 above, especially appraisals of PFM reform and PERs, will usually include observations on the availability of resources in the PFM system, its management capacity and institutional framework. Often public administration reforms and civil service reforms are also ongoing and may provide information about the cross-cutting institutional framework. However, experience shows that information on the support structures and their capacity to develop PFM is less likely to be readily available. It will often be necessary to initiate studies jointly with other aid agencies and government to assess this capacity.

Based on the mapping of the actual situation, the relative importance of the identified capacity constraints to PFM performance can be assessed. In most cases, there will be a need for a capacity analysis based on these and other questions as a complement to the technical system diagnosis of PEFA and other instruments.

5.4.7 Diagnosis of Procurement

An integral part of financial management

Goods, works and services purchased by the government account for a large proportion of public expenditure apart from salaries in developing countries. A weak procurement system – weak legislation, unclear and non-transparent procedures, weak capacity at the organisation responsible – represent therefore in fact a severe threat to development in these countries. Procurement practices represent an integral part of other financial management systems in government. Procurement processes are affected by other PFM systems and, at the same time, affect these systems. One example is audit, where regular financial audits need to be complemented by procurement audits in order to cover the special features of the procurement processes.

Procurement is exposed to corruption in many countries. Goods, works and services are often procured at high values and procurement processes represent a possibility to avoid well-defined and functional accounting and payment registration systems through “kick-back” agreements, bribes, cartel agreements, or the slicing of tenders to avoid open procurement. This situation calls for special safeguards in the procurement process to minimise fiduciary risk.

At the same time, and in the same manner as for the rest of the PFM analysis, the development risk of not utilising the partner government’s procurement system should also be assessed. There are well-defined tools to support this assessment process, which are presented below.

Diagnostic Tools

Procurement is included as one among several important diagnostic tools for measuring PFM system status.²⁹ In addition, there are, in particular, three important standard-setting documents that provide valuable support and comprehensive information for Sida representatives in the procurement area:

- The **Joint Procurement Policy** from November 2004.³⁰
- The **Methodology for Assessment of National Procurement Systems**, with its latest draft from June 2006, has been elaborated in collaboration between OECD-DAC and the World Bank, based on the Joint Venture on Public Procurement sub-working group to the OECD/DAC Working Party on Aid Effectiveness and Donor Practices.
- **Country Procurement Assessment Review (CPAR)**, which has been the dominant tool applied by the *World Bank*, but is now to be replaced by the above-mentioned *Methodology for Assessment of National Procurement Systems*.
- **Sida Procurement Guidelines (SPG)** from 2004

The different contents of these three documents could briefly be expressed as follows: *The Joint Procurement Policy* is a guide to ways of acting in relation to procurement in development cooperation: what should be the point of departure and parameters for actions and reactions. *The Methodology for Assessment of National Procurement Systems* is a very detailed diagnostic instrument on ways of evaluating the status of the partner country’s

²⁹ Such as PEFA, CFAA, regularly in PER analyses and DFID’s FRA analysis.

³⁰ *Joint Procurement Policy*, OECD/DAC (2004).

procurement system, measured with the aid of a substantial number of indicators, both formal and actual compliance indicators. The *Sida Procurement Guidelines* presents procurement rules and regulations, which can be used instead of the national procurement legislation of the partner country.

Procurement in Programme-based Cooperation

The *Joint Procurement Policy* puts procurement in the context of both the harmonisation agenda in general (Rome and Paris Declarations) and the OECD/DAC specific harmonisation work on procurement, the *Methodology for Assessment*, mentioned above.

The Joint Procurement Policy departs from the principle that procurement should be aligned to government systems as far as possible. The policy also includes the responsibility for external partners to support the partner country's need for capacity development of procurement structures.

In a well-defined explanatory note to the policy, the different steps of the procurement process are listed. This presentation serves as a clear guide to the issues that should be discussed in relation to reform work in the procurement area.

In another note, different options for procurement in a programme setting are presented. These alternatives start from full-scale use of the government's regulations and procedures, to procurement undertaken completely outside the government's control and influence.

An assessment of the capacity of, and needs for, the government's procurement structures is well guided by the diagnostic tools presented in the *OECD/World Bank Methodology for Assessment* (and conclusions on procurement issues included in other PFM diagnostic instruments mentioned above).

The Methodology for Assessment presents base line indicators relating to four different pillars:

- The existing legal framework
- The institutional setting
- The competitiveness of the national market
- The integrity of the procurement system (addressing security issues)

These indicators, answering to a scoring system and reflecting international agreement on how a fully fledged and complete procurement system should function, are complemented by compliance indicators making it possible to assess how they actually function in the case in question. In an annex to the methodology, suggested minimum content of a bidding document is presented as an unofficial list of minimum requirements. In the benchmarking compliance and performance sheet also included in the methodology, issues on the integration of the public procurement system with other financial management systems, capacity issues and fiduciary risk assessments are also presented.

The *Methodology for Assessment* stresses the need to look at the circumstances of each individual case and **“assess how the model in place works in terms of outcomes and results”**, i.e. to highlight the actual functionality of the national system already in place.

Sida Procurement Guidelines (SPG)

SPG takes its guiding principles from the *Swedish Public Procurement Act*, supplemented by World Bank, EBRD and WTO guidelines.

SPG sets out the procurement policies, procedures and rules to be followed in Sida-financed projects, reflected as far as possible in the agreements for contracts covering goods, works and consultant services between Sida and partner governments (or corresponding partners to Sida).

In several fields, the rules and regulations expressed in the SPG are different from those included in the *Methodology for Assessment* for the same issue (one example of this is time limits for the submission of bids, among many others). For this reason, it is important to differentiate between, on the one hand, the policies and regulations expressed in the SPG, which are applicable in contracts between a cooperating partner and Sida only, and, on the other hand, procurement regulations in programme-based cooperation, where Sida needs to agree on procurement regulations with several other external actors.

Recommendations

The programme-based approach derives from the *Paris Declaration* and is being increasingly stipulated as the preferred method for collaboration by partner governments. In this setting, the stipulated principles in the *Joint Procurement Policy* should serve as the starting point in discussions on the procurement rules and regulations that will apply.

The *Joint Procurement Policy* looks at procurement in the context of the broader harmonisation efforts in which government ownership and alignment with government procedures and systems represent important features. As with other PFM systems, the starting point in harmonisation efforts and application of regulations and systems should be the existing government procurement systems and the possibility to use and improve these structures.

A risk assessment of the procurement system should include both development and fiduciary risk. For this purpose, the *Methodology for Assessment of National Procurements Systems* could be used to carry out the assessment mentioned in the *Joint Procurement Policy* agreement; either if this assessment has already been made, or as a diagnostic tool to make the assessment. Proposals for reform of the procurement system should look at the actual results and outcomes of the existing system, before any decisions on alterations are made. For this purpose, suggested diagnostic methodologies from both documents could be used.

Harmonised agreement on procurement is a crucial point in programme-based cooperation: in the sector or in cross-cutting reform. Real alignment with government efforts to improve systems and procedures in reform work necessitates a common approach by development partners in relation to procurement regulations. However, in many countries there still are a number of creditors and development partners that impose their own procurement rules. This position represents a heavy additional workload on partner governments and limits the possibilities of making progress with PFM reform. **The application of individual procurement regulations in programme-based cooperation should be avoided.**

5.5 The Assessment and Implications for Financing Modalities

The PFM assessment should be used for decisions on financing modalities by taking into account possibilities of aligning with national systems. The following table illustrates what may be regarded as important issues for the performance of PFM systems, as well as possible risk mitigation measures if the risk in a specific area is regarded as high.

Table 5.2

PFM area	Examples of issues to consider before using government systems.	Examples of risk mitigation measures while still remaining largely with government systems
Macro policy and planning	An overview of government obligations, expenditure, revenue and debt is in place. Positive trend.	Servicing government with external expertise and studies.
Budget policy and formulation	Reasonable contribution to the public budget through taxes, normally not less than 10% of GDP and positive trend. Reasonably balanced budget as a tool for implementation. Budget allocations towards poverty reduction targets and government service to the poor at a reasonable level and improving. Budget deficit should be controlled and not increase. Wasteful spending on public enterprises or an inefficient bureaucracy contained or with prospects of being controlled. Reasonable balance between salaries and other operational costs in key sectors.	Support the budget process with analytical work (PER) and capacity development. Monitor conditions related to financial outcomes at central and local level, increase in general revenue and expenditure trends that support poverty alleviation. Requirements and support to limit spending on public enterprises. Conditions related to contain the total salary envelope and staff component while supporting public sector reform.
Debt and guarantee management	The public debt should be controlled and not be subject to steep increases. The cost of interest on the public debt should be reasonable.	Support to develop debt control and policy. External studies of the debt situation.
Public Revenue collection and administration	A reasonable or growing public contribution to the budget through taxes. A pro-poor tax policy. The tax gap, tax evasion and level of exemptions should be reasonable or conditions improving.	Conditions related to domestic financing and to tax reform. Support to reform efforts.
Budget execution, payment system, accounting and reporting	Annual reports on revenue and expenditure completed within at least six months of the end of the financial year. Monthly flash reports at least within a month. Regular reconciliation between accounts and bank statements. Payments of suppliers and salaries at least within a quarter and arrears controlled and not growing. Suspense accounts reconciled regularly and not growing.	Regular reporting and external audit of accounts and payments. Monitoring of conditions related to reconciliation and timeliness of releases/payments. Use of private financial agents or experts in supporting payments and reporting. Prioritise reform of the government's payment system

Procurement	The process is transparent and allows for scrutiny. Rules allow for reasonably fair competition.	Support and monitor procurement reform and capacity development efforts. Support procurement audits. Deployment of procurement advisor. Intermediate use of a joint tender board, donor procedures and arrangements of “no objection”. External agent used for procurement in exceptional cases.
Audit	Regular financial audit of accuracy of annual financial statements and compliance with financial procedures. External audit reasonably independent and resourced.	Use of audit expertise attached to the audit organisation. Right for development partners to engage their own external audit if needed. Regular external audit by development partners.

Sida’s analysis of risks shall depart from the assumption that the government’s systems shall be used as far as possible. Exceptions from this rule must be substantiated and based on the assessment of risks, the relative trend and reform efforts planned. The risks shall be weighed against the positive effects of using government systems. Some of the potential positive effects are more efficient national systems, reduced transaction costs as compared to the use of parallel systems, improved overview of all resources, and improved focus in the budget dialogue and resource provision.

The result of the analysis may be that some, but not all, national systems can be used or that the national systems shall be used but that, in addition, certain risk mitigation measures need to be put in place.

In cases of doubt of the Government’s capacity to contain risks, it may be necessary to demand and engage in more frequent analysis, audit and control of budget execution records, in order to put on the brakes if funds are poorly utilised or used for the wrong purposes.

The assessment and analysis can, for example, lead to a decision to put the support on budget, i.e. publish it in the budget and make funds available through the treasury system, using government accounting procedures and payment systems, but using an agent to supervise procurement and maintaining the right to call for external audit of accounts.

In addition, while supporting the development of the national systems in these regards, there may be a need to agree provisionally on:

- **financial reporting formats**, including specific reports for purposes of spending, nature of costs, different sources of finance, including off budget flows from other development partners and fees, reports on tracking surveys and spending at local levels and institutions.
- **reporting frequency, timeliness and accuracy**. Normally, the national regulations stipulate requirements on timeliness as regards expenditure returns, production of final accounts etc, and can be used as the benchmark to which adherence can be monitored.
- **audit reports, scope and method**, frequency, timeliness, availability, publicity, actions taken on recommendations.

At the same time, development partners should refrain from requiring too much information and provisionally accept lower levels of information to avoid overloading of

capacity. All requests for additional information should be introduced jointly by the group of development partners concerned. The information should also, as far as possible, be based on what the systems already produce and the management needs of government, and support domestic accountability rather than accountability towards development partners.

Risk mitigation – the example of the Afghan Reconstruction Trust Fund (ARTF)

The ARTF is an example of how to handle a high level of fiduciary risk in a fragile state while still using much of the country's own system.

In Afghanistan payments to the Trust Fund are administered by the World Bank. Development partners transfer their contributions to a World Bank foreign account. Funds are released to a government account in tranches. The procedures applied for the recurrent window under the ARTF largely follow government procedures, use government systems, and contributions are by and large untied. Controls of procurement, of payroll payments against approved staff ceilings, of advances, that funds are not used for security purposes and are correctly processed are made by a monitoring agent before payments are disbursed to the Government from the ARTF fund. Rejected payments are closely monitored and action taken to improve compliance.

In addition, development partners and government have agreed to monitor the performance of the public service through a PAM matrix (Performance Assessment Matrix) covering:

1. Public Finance Management
2. Aid effectiveness and mutual accountability
3. Education
4. Health, and
5. Public Administration Reform

Critical questions:

- What aspects of all those to consider seem to be most critical for Sida (corruption, procurement, audit, budget allocation and poverty focus, payments, accounting and reporting, PFM capacity, macro balance, political commitment)? Which ones are reasonably well covered by diagnoses, which ones seem to need an extra diagnostic effort? Determine the need for extra studies and seek alliances and support to conduct such studies.
- What is the position of other development partners – is there a group of like-minded development partners with similar interests and conclusions with whom Sida can co-operate and join in diagnoses, funding and risk mitigation arrangements? Liaise with such development partners.
- Can Sida participate in and support a PEFA assessment or other necessary diagnoses or studies? Can Sida influence the process to create ownership and learning? Try to find ways to participate in and influence the assessment process.
- What conclusions can be drawn from the assessments? What are the critical deficiencies? What are the potential positive effects of harmonisation as compared to the risks? What is the general trend? What constitutes an unacceptable standard for use of government systems? Is there a need for specific risk mitigation measures if one is to use government systems? Which measures would be relevant?
- Is the assessment consistent with the actual conditions on the ground? How well does the PFM system function for disbursements of funds and their transformation into service delivery compared to the results of the assessment? Revise the conclusions if necessary.
- Are efforts being made to reform PFM systems? What credibility does the government's PFM reform efforts have?
- What are the final conclusions on Sida's part as to aid channels, risk mitigation, choice of partners and modes of operation? Summarise Sida's position, make recommendations. Use the format in chapter 2, section 2.2.

6 PFM Reform

This chapter describes the PFM reform planning process that often follows the PFM assessment; starting with the results of diagnostic studies up to the fully designed PFM reform programme. It captures the main steps of the process and highlights specific questions of importance for a successful programme: for example how coordination and ownership is secured, the choice between different reform strategies, sequencing and prioritisation of efforts, and the design of targets and monitoring mechanisms.

In this chapter you can read about issues linked to the planning and composition of PFM reform programmes such as:

- **Strategic issues for poverty reduction**
- **Preparation for PFM reform**
- **The importance of an agreement with the government on PFM reform**
- **The importance of ownership and understanding of the reform**
- **The importance of feasibility in reform work**
- **The need to sequence and prioritise reform**
- **The importance of institutional arrangements in reform work**
- **The introduction of institutionalised monitoring and evaluation**

6.1 Introduction to PFM Reform

In line with the OECD-DAC strengthened approach, development partners have agreed not just to support PFM diagnoses (through the PEFA instrument presented in chapter 4), but also PFM reform efforts. Hence, plans to support a PEFA assessment should also include joint development partner assistance to capture and disseminate the result, to undertake further in-depth diagnoses, and to prepare support for PFM development reforms. It is important that the in-depth analysis of the diagnostic results and reform planning is government-led, and supported with technical assistance when needed.

Consideration should be given to the following when planning and designing a PFM reform programme:

Planning of PFM reform – What to think of

- Start with the strategic issues for poverty reduction identified via the PFM assessment;
- Prepare for reform planning, study ongoing reform activities and plans including evaluations of previous reforms to ensure that lessons learnt are captured;
- Ensure a fruitful linkage to other related public reform initiatives;
- Secure agreement with government on problems and the desired outcome of reform;
- Build ownership, understanding and commitment during reform planning by close involvement of the government as early as in the assessment phase;
- Choose a feasible reform strategy – build upon what already exists;
- Make priorities and sequence – use Sida's two perspectives to ensure a poverty focus;
- Consider the organisational and institutional set-up for PFM reform;
- Secure and include monitoring and evaluation arrangements for the reform programme.

In the following sections these different aspects of PFM reform planning are presented in detail. It is recommended that the entire chapter should be studied when Sida participates in PFM reform activities, irrespective of whether reform activities are just being introduced or are well established. In addition, it may be useful to consult the OECD/DAC *Good Practice Note*, which has the advantage that it has been adopted by all development partners.³¹

6.2 Start with the PFM Constraints to Poverty Reduction

From the PFM assessment, discussed in chapters 2 and 5, there should be an understanding of the major constraints to poverty reduction caused by weaknesses in the PFM system. This should be the starting point that guides reform planning. It is easy to lose sight of the purpose of the reform when moving into the detailed planning of desired activities at the technical level. Read more about this in the section below on prioritisation of PFM reform.

³¹ *Budget Support, Sector Wide Approaches and Capacity Development in Public Financial Management, Harmonising Donor Practices for Effective Aid Delivery*, Volume 2, DAC Guidelines and Reference Series, OECD (2005).

6.3 Prepare for Reform Planning

6.3.1 Increase Capacity for PFM Reform Planning

There are a number of typical capacity problems related to the planning phase. There are usually only a few people that have overall knowledge of the entire PFM system. At the same time, few are thoroughly acquainted with international standards and best practices. This situation carries the risk that analytical work may be done by external experts and this may lead to flawed ownership of the diagnosis. There is also a risk that a few knowledgeable employees formulate overambitious and unrealistic targets and solutions for the reform which do not consider the need of getting other professionals on board.

The ability of the partner country, usually represented by the MoF, to critically review a diagnosis may be limited which, in turn, may lead to acceptance of proposals that are found to be unfeasible at a later stage. Development partners need to provide space, allow for consultations, and refrain from driving the process. Reform needs to be anchored in the perception of the government in order to be feasible and sustainable in the long run.

Capacity weaknesses risk having the effect that the reform planning process drags out in time and that gradually the initiative is taken over by external experts supplied by the development partners. In order to mitigate these risks, it is necessary to allow time for capacity development and consensus building measures during the planning and design phase. Involvement and interaction between external advisors and government representatives are the key to progress. It takes time to build understanding and study options. At certain stages, study visits to countries that have experienced similar problems and solved them can be useful. A thorough joint review of reform plans by the government and by donors and external experts should also be included in preparations.

Comprehensive reform programmes usually have a time perspective of 10–15 years. This will allow capacity development measures to start at the earliest stage of reform planning without necessarily delaying the reform work. However, in practice, there may be a conflict between this view and the desire of certain donors and government to start implementation at the earliest possible date without providing scope for capacity development. The result may be the early production of reform plans that can be characterised as shopping lists rather than reform efforts. There will be a need for a strategy on when and how to use technical assistance and also to liaise with and incorporate on-going reform efforts in order not to waste knowledge and lose momentum.

Another approach is therefore to “start small” with early capacity building initiatives related to PFM benchmarking and regional study tours, and training in change and reform management. Also some reform efforts – starting from the government’s reform agenda – that can lead to results within a short period can be supported before the whole reform design is agreed. Analysis and planning can then go on in parallel with these early efforts.

6.3.2 Development Partner Coordination in the Planning Phase

There may not be a proper forum and arena for dialogue between development partners on how best to support a PFM reform, although several development partners have identified PFM reform as critical. The dialogue with government on PFM issues may take place on a bilateral basis with diverse approaches and high transaction costs.

The MoF may face difficulties in dealing with that situation. Sida staff have an important role to support and initiate efforts for donor coordination and harmonisation for PFM reform. The first step could be to establish a single development partner-government interface and forum.

6.3.3 Political Support and Motivation

The political motivation to improve the existing PFM systems would normally emanate from the detrimental effect a malfunctioning PFM system has on service delivery and the achievement of poverty reduction targets. The reform may also be triggered by the diagnostic studies, and be further motivated by the fact that development partners are more inclined to channel aid as budget support if certain basic conditions related to the PFM system are met. The possibility of receiving more support is likely to increase with an orderly PFM system which delivers where poverty alleviation targets are concerned. Sida can create awareness in the partner country's leadership of such benefits of PFM reform and support efforts to allow politicians, media and civil society to follow policy implementation and reform progress.

6.3.4 Mobilisation of Support from Line Ministries

Some support for reform work may already exist in the MoF, especially at the political level. Other ministries may not, however, share the understanding of the needs for PFM reform of the MoF, and there could be weak cooperative relationships between the MoF and line ministries.

Sida, as a major development partner in many sectors, can promote the active participation of line ministries in PFM reform planning and also provide support to improve the capacity of line ministries to become competent clients and users of the central systems, and to address their own PFM development needs.

6.3.5 Incentive Structures

In a number of countries, the performance of the public sector and its PFM system is hampered by poor incentive structures. Extremely low salaries may lead to weak incentives and generally poor performance of the system. Assignment of PFM staff by the MoF to the sector may create negative incentives from the sector to "invest" in skills development for this category of staff. Capacity may also be threatened because the private sector or development partners absorb recently graduated PFM professionals. This may be regarded as a killing external factor to reform which cannot be addressed by the PFM institutions alone, as the powers to change incentive systems often lie with the personnel management authorities. Hence, there may be a need to look into these aspects and to mitigate risks by special schemes and arrangements over the reform period. For sustainability in a longer perspective, more thorough reforms will, however, be needed, in interaction with other actors.

Sida should ensure that this issue is covered by the PFM diagnostic studies and, if regarded as a major problem, addressed within or outside the PFM reform plan.

6.4 Build Ownership, Understanding and Commitment During Reform Planning

A PEFA assessment and many of the other assessments described in chapter 4 are not, in themselves, a sufficient base for PFM reform planning. Further in-depth analysis is normally needed. The PEFA indicators describe PFM performance at an aggregate level, for example regarding arrears or budget variance. There could be a wide range of underlying issues that need to be analysed and addressed to resolve the situation and improve on the PFM system performance. In most cases, it is necessary to improve rules, methods and procedures in all main PFM components, reorganise and develop capacity at individual, organisational and institutional level, analyse HR aspects etc.

To prepare a feasible reform plan and to build ownership for the plan, the main stakeholders need to be engaged in in-depth analysis, problem identification and project design. The stakeholders involved would include line ministries, key cross-cutting government organisations (*Ministry of Finance and Planning, Public Service Commission, Ministry of Local Government*), parliamentarians, the revenue and customs authority, representatives of civil society, and representatives of decentralised administrative levels etc. Through their detailed local knowledge of the circumstances in the country, they will provide invaluable contributions to identify underlying problems and feasible solutions reflecting locally formulated priorities. The success of PFM reform is critically dependent upon ownership of the problem and solution formulation.

At times, the MoF may lack the ability and/or willingness to mobilise stakeholders outside circles close to it for PFM reform planning. This may contribute to the elaboration of unfeasible reform proposals, and lack of necessary ownership at the implementation stage of the process.

Sida can play an important role to promote and ensure that a thorough problem analysis is carried out, and that ownership is built through the participation of all key actors and stakeholders. Government and its stakeholders need to agree on the main problem areas and targets for the reform before the reform can receive support and be implemented.

6.5 Choose a Feasible Reform Strategy

6.5.1 A Comprehensive Reform Programme, Isolated Reforms or a Hybrid Approach?

One issue that features in the design of PFM reform programmes is whether or not they need to be comprehensive and include all the different PFM components. An alternative solution could be a hybrid programme where some efforts are coordinated and brought under one management and monitoring umbrella, whereas others are planned in isolation. A third option is a fragmented approach allowing each component to do its own planning and seek its own financing.

Experience gained from fragmented approaches in several countries is that reforms may well have been ongoing for many years without much progress being achieved because the inter-linkages and connections in the PFM system have not been adequately addressed. The budget department has had its own projects, trying to implement MTEF and programme budgeting without considering the accounting and reporting structures

and actual expenditure commitments. IFMIS³² projects may have started with the computerisation of existing routines and accounts, only to find that the staff trained leave for the private sector due to poor remuneration and career prospects, or that the designed system cannot accommodate new budget structures and that the programmers have left. At times, changes in systems are introduced without corresponding and necessary legal changes. In some cases, the IFMIS and payroll systems are designed separately and in isolation. These problems are often worsened by poor coordination between development partners. The final outcome of such reform efforts has been limited.

However, even if, in general, dependency between PFM components is high, there may be reforms and efforts with less interdependency that could be developed more on their own – such as the customs system or tax administration. The linkages are obviously there, but may not merit continuous internal coordination. Including such efforts in a comprehensive programme may, however, have some other benefits – reduce the transaction costs of development partner integration and harmonisation, and strengthen the mutual understanding of roles and responsibilities within the PFM system.

The PEFA assessment framework is, in itself, an important development – away from fragmented and narrow diagnostic instruments towards comprehensiveness.

Sida recommends a comprehensive, or at least hybrid, approach to PFM reform, meaning that all related reforms in the PFM field are captured within one management and monitoring framework, and that the financing of such reforms should be well coordinated, brought on budget if feasible, or supplied through a basket arrangement. The approach is, in essence, that of a programme-based approach for the PFM sector using a holistic approach for needs assessment and planning, and at least giving an overview of funding and support arrangements.

The need for overview and comprehensiveness is likely to be greatest in the diagnostic and reform design phases. It is then that it should be possible to identify reform efforts that can stand on their own and receive their own management arrangements. In the reform implementation phase, there should be an element of rationalisation of the coordination machinery and the comprehensiveness of the PFM reform programme, restricting it to components with a high level of interdependency. Otherwise, there is a risk that everything that is connected in one way or another will be included, paving the way for another disaster programme, this time due to an overburdened co-ordination and management framework.

In the case of reforms of the external audit organisation or the parliamentary budget committee, there may also be other considerations that lead to separate reform projects. These entities have a supervisory role and therefore need to develop their own methods and PFM capacity, without having to relate to, or obtain permission from, the MoF in the process (e.g. financing reform of the *Supreme Audit Institution* through a programme managed by the MoF would normally even contradict the national constitution and hence sidestep national accountability mechanisms).

³² *Integrated Financial Management Information Systems* – see further chapter 6 on special reform issues.

6.6 Prioritise and Sequence Activities and Targets

6.6.1 Sequencing

With a comprehensive approach, the reform agenda tends to become extensive. Many reform plans start off with a large number of reforms of a number of aspects such as legislation, systems, procedures, training and guidelines, all to be concluded within a very short period of time. Most of these reform activities are meant to be undertaken by a central MoF that is already overburdened by its ordinary operations in highly prioritised areas such as budget formulation and execution. Therefore, there will be a need to design a reform plan which is more realistic and places a reasonable annual workload on the institutions involved. **Criteria for prioritisation should be to remove binding constraints to poverty reduction/service delivery.** Here, a rights perspective and the perspectives of the poor on development are useful tools to ensure a poverty-focused reform and balance a fiduciary perspective with a developmental perspective.

Each reform and component may also, in itself, need a certain logical sequence of activities: the legislation will need to be drafted and enacted before some of the new procedures can be rolled out, the computerisation of a system/procedure must go through needs analysis, technical specification, process mapping, tender processes, design and installation, training of super users and end users, and testing before it is up and running.

A realistic time frame for PFM reforms that involve revised legislation, new systems and procedures would be not less than 10 years. A full roll-out and change of culture and responsibilities down to service delivery levels may well take 15 years.³³

The question hence arises of the overall sequencing of the PFM reforms, considering the interdependencies, workload and critical paths. Is there a best way to do things and what has proven to be successful? The attempts with comprehensive, sequenced programmes are fairly new and therefore no final conclusions can be drawn yet. However, some new schools of thought have emerged that relate to the sequencing of PFM reform.

One approach that is being applied is referred to as **the platform approach**.³⁴ The reform plan defines a series of platforms over time. For each platform, a number of outcomes are to be reached. One platform is meant to pave the way for, or to enable, the next platform. For example, the shaping of a credible budget, with predictable budget releases and reduced variance between budget and final expenditure at year-end, could be defined as an outcome for an early platform that improves basic service delivery and resource management and gives credible information flows in the system. Having reached those targets, it would be possible to introduce MTEF, to delegate financial authority and hold budget managers accountable for their budget execution. This, in turn, would be an enabling platform for results-based management, better poverty targeting of the budget, improved cost-efficiency etc. The sequencing should be set in relation to the specific country circumstances – the example below is just one way.

To start work to reach a later platform does not necessarily mean that all earlier platforms must have been reached. Preparation for new legislation or investigation of the needs for a new IT system may very well need to be undertaken in parallel with

³³ *Best Practice in Building African Capacity for Public Financial Management – The Experience of NORAD and Sida*, Göran Andersson and Jan Isaksen, Sida (2003).

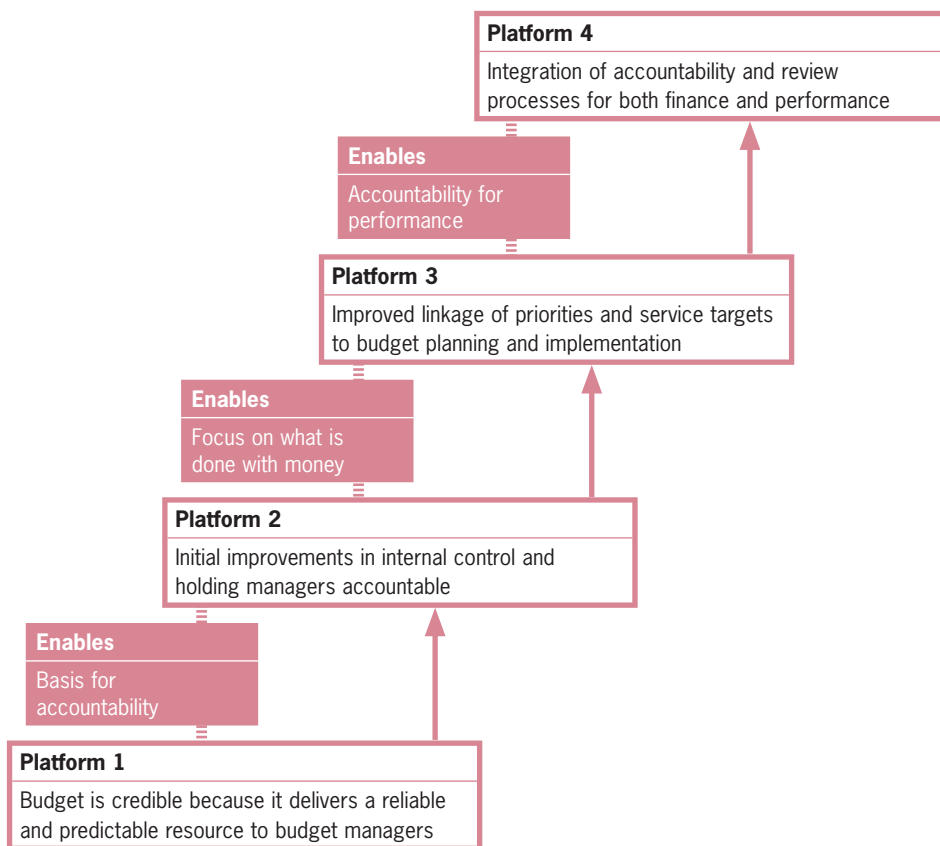
³⁴ *A Platform Approach to improving Public Financial Management*, Briefing Note, DFID (2005).

earlier platform work. Some outcomes will also be promoted in several platforms, such as poverty reduction which may be supported first through improved payments and disbursements of funds to service delivery institutions and, later, through the introduction of increased accountability and results-based management.

The platform approach also aims to give a more reasonable workload over time, considering available capacity and the existing policy, while demonstrating tangible measurable progress at each platform along the way.

An approach which can be described as **“getting the basics in place first”** has also been discussed, mainly in *World Bank* circles³⁵. It has much in common with the platform approach. The recommendation is that it is important to get basic order in place for payments, accounting and budget releases before it is possible to introduce concepts such as programme budgeting, accrual accounting and advanced IFMIS systems including modules for commitment control, payroll and budget formulation. Before an IFMIS is considered, it may be worthwhile to computerise registration of transactions in the central general ledger, which is the central database for all transactions. Limited computerisation of this type could still speed up reporting, enable advanced search functions, and facilitate reconciliation of accounts with payments – and that at a very modest cost.

Figure 6.1 The platform approach – an example



³⁵ P8, *Public Expenditure Management Handbook*, World Bank (1998).

The assessment of capacity issues will determine both the feasibility of other planned and necessary reform efforts, the time span needed for a PFM reform, the sequencing of reform activities and capacity building efforts, as well as the extent and nature of needs for technical assistance. The weaker the capacity of the organisation is, the longer the reform period needed and the greater the emphasis on thorough capacity building will be. There might also be a need for interim gap-filling with external expertise to cater for the PFM operations during the reform and capacity building periods.

Another approach to sequencing and the definition of platforms is being tried in Russia, where it was recognized that delegation of financial powers to budget holders and the introduction of results-based management were essential first steps to create interest and engagement in the PFM reforms. Budget holders in government are meant to become drivers of reform and request management information from the systems, and therefore have an interest in the development of budget and accounting systems and structures. The background to this was, however, that Russia was considered to have much of the basic system order in place.

Common to all approaches is that reform design cannot be a blueprint for use in all countries, but needs to be adapted to the unique conditions of each country.

6.6.2 Prioritisation

Although sequencing implies a spread of reform work over time, it does not necessarily mean that reforms are prioritised or taken off the agenda. There is a tendency that everything is given top priority. Making priorities that take into account limited resources in terms of funding and staff is often needed. Some guiding principles in this regard can be:

- to group the reforms into categories of high, medium and low priority, depending on impact in terms of risk reduction, improved service delivery and effectiveness in general, and consider scrapping or postponing the low priority reforms. Poverty reduction can, in this process, be used as a restriction, a condition for acceptance. In situations with a poor resource flow to budget holders and poor budget credibility, reform efforts towards payment systems and budget releases would, for example, be expected to get high priority, whereas improved asset registration might, for example, get lower priority. Use the perspectives of the poor on development and a rights perspective as a tool when making priorities.
- to consider options with lower costs, especially for IFMIS and other capital intensive investments where there may be cheaper solutions that still satisfy most of the urgent needs. A fully fledged IFMIS with a whole set of modules and user licences is quite expensive, whereas basic computerisation of the general ledger³⁶ may be an inexpensive start, sufficient for the initial requirements and for lower levels of government. It may also contribute towards improving capacity to take more advanced steps at a later stage.

Sida and other development partners need to scrutinise major cost elements and the priority order of the suggested reform efforts. A cost benefit analysis can be conducted that takes into account major cost elements and the expected benefits in financial terms, in relation to poverty reduction and service delivery, and other desired results.

³⁶The general ledger is the database/record of all financial transactions.

6.7 Consider the Organisational and Institutional Set-up for PFM Reform

A comprehensive and sequenced approach to PFM reform and to the system as such recognises the dependencies, linkages and needs for coordination. The reality in the country can well be that PFM responsibilities and systems are distributed over a number of institutions without sufficient coordination and that the institutional setup and weak overall management are major obstacles to progress. There may also be poor recognition and understanding of dependencies. A typical example of this is the division, in many countries, into a planning and budget ministry and a ministry of finance which is responsible for budget execution of recurrent costs only.

For a comprehensive reform to succeed, it will then be necessary to **engage not only the MoF, but all the external, major institutions as well as line ministry representatives in different phases of reform**. Examples of external institutions that may need to be included are: the revenue authority including taxes and customs, the debt office, the planning ministry, the national audit office, and representatives of line ministries, provinces and districts. If there is a central agency responsible for IT standards and infrastructure for government, it should also normally be involved. Institutions such as the *Public Service Commission*, *Department of Personnel Management*, the *Prime Minister's Office* and the *Office of the President* may be important stakeholders for public service reform and reform of incentive structures and schemes of service, and therefore need to participate in PFM reform. Parliament should be informed and be able to comment upon PFM reform. Moreover, it has an important role as the decision-maker on the budget and in its oversight function. Involvement of the public accounts committee and budget committee may thus be desirable, depending on the scope of the reform.

Normally, a **PFM reform committee** or steering group needs to be created, led by someone representing management level at the MoF (or ministry of planning) with members from the main institutions and departments involved. The arrangement should ideally include representatives of some line ministries. At times, there can be a wider reference group for consultations with these ministries. In several countries, a separate technical committee or advisory group has also been established, consisting of technical expertise from the various components, with the aim of discussing and resolving technical issues related to system design, legislation, training programme design etc.

In situations with a large group of development partners, a parallel development partner PFM committee has often been established to coordinate and harmonise support to the reform. One or two representatives of the development partner group may also be invited to take part in the PFM reform committee meetings, in some cases as committee members – however, more often as observers.

Promote development partner coordination and take an active part in the development partner and reform committees in countries where Sida supports PFM reform. Support efforts to create reform coordination mechanisms in the partner country and continuously support government's coordination efforts to avoid diverse and conflicting agendas.

A comprehensive and well-coordinated PFM reform will also require an arrangement with a reform secretariat or coordination unit, which should be an integral part of the government structure. It would be responsible for the coordination of planning, budgeting, monitoring, evaluation and support to component managers and the reform committee. **The responsibility for the reform work should, however, rest with**

component managers that also are responsible for, and conversant with, the corresponding day-to-day functions and operations. It may be necessary to strengthen the components with temporary staff and expertise to ensure that both reform work and day-to-day operations can be continued without interruption. Be sensitive to the need for such support but work actively against the creation of separate programme management units (PMUs) that take on the responsibility for design and implementation of the actual reforms – operational line units should be involved and carry the main responsibility.

6.8 Secure and Include Monitoring and Evaluation Arrangements for the Reform Programme

A reform plan should include measurable milestones, regular reviews and assessments of progress to which development partners should also subscribe. The illustration below presents some possible outcomes and outputs of a PFM reform programme.

PEFA benchmarks alone will not be sufficient to measure PFM reform progress. In addition, there will be need to follow up the specific targets, milestones and activities identified for the country-specific PFM reform programme, including capacity issues.

It is important to remember to **uphold priorities in the formulation of indicators for the follow-up of the PFM reform programme** and to ensure that these correspond to the “basic rights” concept.

For each outcome and output it is possible to define specific **measurable performance indicators** such as budget variance, results from user surveys and *Public Expenditure Tracking Surveys* (PETS), time span between purchase orders, payments and financial reports, tax compliance described as the gap between debited and collected tax etc. The establishment of baseline data, indicating the situation at the start of the reform programme, is recommended. Specific targets related to the performance indicators should be formulated with target dates for the outcomes and outputs, so called reviewable milestones.

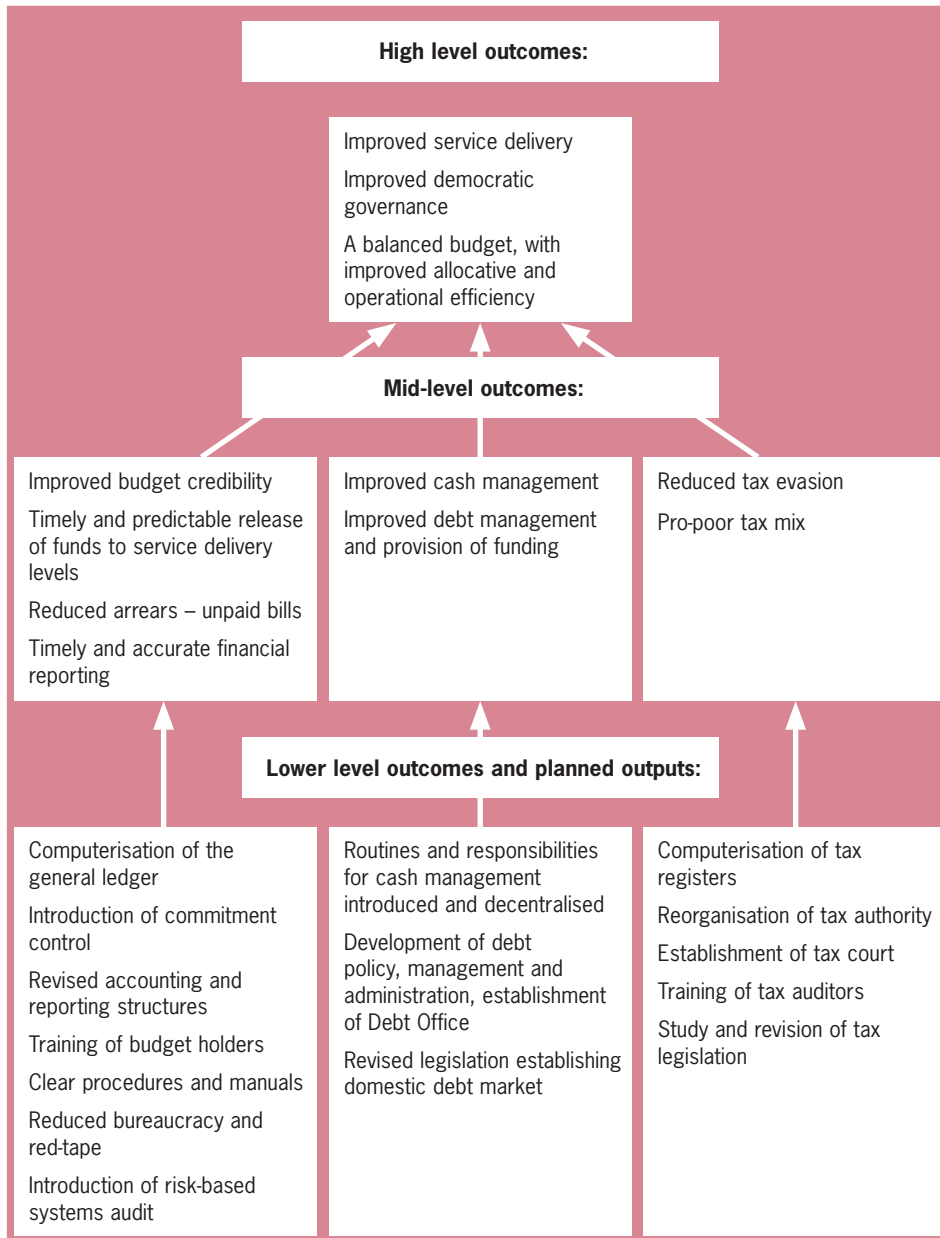
Also, high level benchmarks should be assessed at regular intervals. This could be done through regular PEFA assessments, but would also require feedback from sectors, tracking surveys, reports on service delivery, accountability etc.

It is, of course, not possible to prescribe the reform agenda, the expected outcomes and necessary outputs or the sequence – it all depends on the national context and political priorities. In one country tax compliance may be the biggest problem, whereas in another a reliable payment system may be the main issue.

Mechanisms must be in place to continuously revise and adjust the plans and efforts to meet new challenges and unforeseen obstacles. The high dependency between components calls for continuous monitoring.

Sida should assist in the development of the reform plans whenever necessary and **ensure that expected results are well formulated and quantified with measurable indicators and a baseline** description where feasible. Also methods, frequency and report formats should be agreed beforehand in the reform documentation. In some instances, external evaluation should be requested. Arrangements for continual external monitoring of reform progress through an independent quality assurance group (QAG) can also be valuable and, if deemed so, should be supported by Sida.

Figure 6.2



Some issues to think of related to PFM reform:

The planning process

- The planning of the PFM reform agenda should start from the government's agenda or on-going reform in this area. Issues especially important for the possibility to enhance the capacity of the PFM system for service delivery should be prioritised.
- Ensure that it is possible for sector representatives to participate fully in the formulation of new PFM procedures or PFM systems as part of the reforms.
- The step from PEFA assessment to a reform programme necessitates more in-depth analysis, involving stakeholders. Support wide stakeholder participation.
- It is normally necessary to also cover capacity aspects, such as competencies and staff qualifications, institutional training available, accreditation, incentives, the institutional set-up, HRM etc.
- To achieve transparency and accountability, the engagement of stakeholders such as parliament, NGOs and end-beneficiaries is essential.
- There may also be a need to include elements of training, study visits, bench-marking as early as in the reform planning process in order to expose the partner country stakeholders to other systems and methods.

The reform strategy:

- For reform implementation, a comprehensive approach (but prioritised and adequately sequenced) should be applied if feasible. A hybrid approach can also be used in which areas that are not strongly dependent on each other can be broken out and run in isolation, but dependent functions are kept under a common management, funding and monitoring framework.
- Ensure that PFM reforms are prioritised and sequenced in line with a manageable reform work load.
- The reforms should also be sequenced in order to give priority to basic enabling systems and functions.
- Promote prioritisation of the reforms that matter the most for the poor by making use of the perspectives of the poor and a rights perspective.

Monitoring and evaluation:

- Work actively to ensure that agreement is reached on joint monitoring and evaluation mechanisms, including measurable performance indicators, baselines and milestones.
- Promote flexibility: any plan may need to be adjusted, resources reallocated, new problems addressed etc.
- The extent to which resources reach service delivery units is critical and should be monitored through indicators of lower level execution and by regular public expenditure tracking surveys (PETS) where necessary. Work to ensure that such studies form part of the agreed monitoring format and methods as a complementary measure.
- Provide support to ensure that monitoring and coordination of a comprehensive PFM reform programme is given a high profile, a full time job, but that departments and authorities are relied upon to implement the reform plan.
- Engage parliament, civil society, end-users and media.

7 Specific Reform Issues

This chapter presents certain specific reform issues that need to be included for the reform approach to be feasible. The issues identified relate to capacity development, anti-corruption, procurement, computerisation of PFM systems and oversight functions.

In this chapter you can read about PFM and

- **Capacity issues**
- **The legal framework**
- **Functional reviews**
- **The new role of the Ministry of Finance**
- **The IFMIS**
- **Corruption**
- **Oversight issues – The role of parliament and audit institutions**

7.1 Reform and Development of PFM Capacity

In planning and designing PFM reform programmes, it will be necessary to make in-depth analyses of capacity aspects at the level of organisational units at, in particular, the ministries of finance and planning, major sector ministries and samples of sector and finance departments at sub-national levels. The capacity analysis would also normally benefit from including the institutional framework and, wherever relevant, contextual factors.³⁷ Such analyses should form the basis for the identification and design of capacity development measures for the reform programme.

The nature of capacity building programmes required will differ between the design and implementation phases of PFM reform. In the design phase, fewer staff will be involved (although consultations are ideally wide), but there will be more issues and options to consider and master. In the roll-out and implementation phases, a large number of officials must be given orientation and skills to master new systems and procedures and follow new legislation and guidelines. The staff should also be given the “big picture” of PFM, its purpose in relation to service delivery and poverty reduction, as well as an understanding of the different parts of a PFM system.

External expertise is normally required to assist in reform planning and design. It is necessary to ensure that a proper balance is struck between technical work to be done by external experts and capacity development through coaching and training. The deployment of external experts has to be coordinated by government, and also between donors providing funding. Continuity should be sought in utilising same experts over the whole planning and design phase to facilitate smooth cooperation between local expertise and consultants and coherence in views on needs, approaches and reform measures.

The table below shows a practical example of capacity development measures that could be necessary during the planning and design phase.

Table 7.1

Target group	Capacity development needs	Measure
Political level and top management	Reform strategies and change management	Change management and “best practices” seminar
	Knowledge of “best practices” in PFM Development partner policies	Monitoring and demonstration of political gains along the reform process and the link to poverty reduction. Regional study tours (e.g. re IFMIS; budget management)
Reform managers from government	Reform strategies and change management	Change management and “best practices” seminar
	Knowledge of “best practices” in PFM Programme /project management	Seminars on programme/project management and development partner policies
	Development partner policies and financing modalities	– Quarterly/bi-annual seminars with project teams to share experience
	Benchmarking continuous improvement SWAp	– Coaching/mentoring through TA SWAp training
	Facilitate their understanding of the PFM system as a whole and its role in relation to service delivery and poverty reduction.	

³⁷ Sida’s policy and manual for *Capacity Development* roughly identifies five levels of analysis, which might help in identifying strategic priorities for capacity measures. These are: (1) Individual; (2) Organisation; (3) System of organisations; (4) Institutional framework; and (5) Environment/Contextual factors.

Target group	Capacity development needs	Measure
Project leaders /team leaders	Project management	Short-term course including coaching /facilitation and team building skills.
Project teams	Team building Harmonisation of regular duties and project work Project planning/work planning Project cycle management including M&E of result indicators Knowledge of specific techniques and methods needed by individual team members	Tailor-made teambuilding and project planning workshop Identify specific needs of training within teams which would, if provided, enhance capacity to implement the project Seminars with project teams to share experience On-the job coaching by LTA/STA
Internal stakeholders	Enhance knowledge of design options /feasibility tests	Workshops with departments concerned
External stakeholders	Enhance knowledge of design options /feasibility tests	Workshops with stakeholders concerned (ministries/provinces/donors)

When the design phase has been finalised, full-scale implementation commences.

It may sometimes not be technically or economically feasible to have a full-scale launch over the whole government. Implementation may take place in stages, with a few ministries and/or agencies at a time.

Implementation may also necessitate extensive work to adapt systems, processes and guidelines to the specific sector environment. Extensive training (ideally a combination of classroom and on-the-job training/coaching) should also be included – it will not, for example, suffice to distribute a circular if a new procurement procedure is to be implemented. This aspect is often neglected in an environment where changes have been few and reform scarce or where a war-torn country is struggling to establish a functioning public service.

At the managerial level, the capacity constraints are manifested in the form of competition between time devoted to reform management and to management of regular operations. Typically, the management of regular operations is given priority and development partners may, at times, contribute to this by their requests for short-term measures and fire-fighting. Key professional staff involved in reform work are usually also key staff in regular operations and therefore also required to give priority to regular duties, which may give rise to conflicts. Moreover, the delegation of decision-making powers is typically very limited, making it necessary for decisions to be pushed up in the hierarchy – leading to delays in the decision-making process needed to move the implementation of reforms forwards.

There are no quick fixes to these capacity constraints if interventions are intended to be sustainable. Technical assistance is the most common method used to mitigate the weaknesses and is usually necessary, but it cannot make up for the great numbers of managers and finance management staff involved when PFM systems changes are rolled out in the public service. The only feasible solution to this dilemma is to **roll out reforms in such a way that management and technical training and other capacity development measures such as recruitment and redeployment have a chance to bear fruit.** This necessitates definition of priorities and that reform is introduced in proportion to capacity. The need for TA support can, at times, also be substantial. However, the design

and use of TA interventions must always be critically questioned. Can regular staff in one ministry support, train and advise the staff of another ministry? Is the design of the TA intervention conducive to strengthening ownership, allowing enough time for this to happen? Is there a need to temporarily hire backstopping support to perform of regular duties, while the managers and technical staff learn the new system? What combination of specialist and general PFM knowledge is adequate?

The table below shows a practical example of capacity development measures that could form part of a plan to implement PFM reform.

Table 7.2

Target group	Capacity development need	Measure
MoF departments, managers and staff	Learn new methods, techniques, rules and procedures related to reform content IT applications	Training courses Manuals Handbooks Workshops, seminars Specialised institutional training for professionals Establish or develop training functions in the ministry or special institutions Provision of advisors and temporary gap-fillers
Operational staff in ministries and provinces	Learn new methods, techniques, rules and procedures related to reform content IT applications	Training courses Manuals Handbooks Specialised institutional training for professionals Establish contacts with/develop capacity of sector ministries/provinces to deliver training Develop capacity of training institutions to assist and to maintain sustainable training capacity Provision of advisors and temporary gap-fillers Help-desk function and FAQ services ³⁸
Managers of finance departments in ministries and provinces	Philosophy and rationale of the PFM system and its reform Reform content and utilisation of new system	Workshops/seminars/courses by PFM reform management. User-friendly manuals. Provision of advisors and, if need be, temporary gap-fillers.
Line managers /budget holders	Philosophy and rationale of the PFM system and its reform Reform content and utilisation of new system	Workshops/seminars/courses by PFM reform management and training institutes. User-friendly manuals.
Ministry and province leadership and managers	Knowledge of reforms and implications for leadership Change management	Information and communication activities through written information and conferences/seminars organised by PFM reform management
Training and education institutions	Develop and adapt training content to skills needs for new systems	Develop capacity of education and training institutions to upgrade staff in the PFM system and supply candidates for recruitment Advisors and TAs.

³⁸ Valid for all technical level solutions.

In many countries, there may be a need to consider how the availability of suitable candidates for PFM positions in government can be promoted through improvements to the quantity and quality of academic pre-service programmes. Also, government officials could be considered for such in-service programmes or for specific academic crash courses, leading to opportunities for similar accreditation. In situations with limited skills (individual skills, knowledge), long-term training programmes may be the only possible solution. Employees attending long programmes may need to be replaced by temporary staff to take care of the regular operations during the study period.

Experience tells us that one of the most efficient ways of building HR capacity is on-the-job training, i.e. for a knowledgeable person to assist directly in the working process in the presence of relevant staff, making direct application of a real life situation possible. The possibility to install a support function (help desk or equivalent) that can rapidly answer questions at a distance and/or make “house calls” to the ministries/agencies in question can be another method for the smooth implementation of PFM reform.

The guidelines published by OECD/DAC on capacity development in PFM and accepted by all major donors, are fully in line with Sida’s policy on capacity development and should be used in the dialogue with the development partners.³⁹

7.2 Reform of the Legal Framework

The legal framework that guides the PFM functions and processes is often quite elaborate with a number of different acts of parliament that guide the budget process and structure and parliament’s involvement, the auditor general’s role and office, procurement procedures, financial management and accountability, public debt and guarantees, etc.

In addition to the acts of parliament, there are normally a number of bye-laws, ordinances and decrees that may be issued by the cabinet, the president or the minister of finance.

Finally, there are normally more specific guidelines, manuals and procedures that can be laid down by the ministry of finance, or by specific officers, such as the auditor general, accountant general or budget director.

The reform of the PFM systems often necessitates changes and additions to the legal framework. In designing the reform, it will be necessary to consider the chain of activities, since amending an act of parliament is quite involved and must cover a certain time span. It is normally a matter of consultations, drafting a new law, further consultations, obtaining cabinet approval, tabling the bill to parliament, awaiting one or two parliamentary sessions (two with an election in-between for constitutional changes). When parliament has passed the bill, the president must promulgate the law and allow sufficient time for it to be properly implemented. The enactment may also necessitate redrafting of bye-laws and regulations, design of new processes and forms, new institutional arrangements, and training before implementation can take place.

Some caution should be exercised not to include minor issues that may need frequent amendments and changes in laws. It is much easier to implement changes that only need cabinet or lower level approval. However, traditions vary between countries in this respect – in some Latin American countries, certain sector/agency budget allocations are determined by the constitution.

³⁹ *Budget Support, Sector-Wide Approaches and Capacity Development in Public Financial Management, Harmonising Donor Practices for Effective Aid Delivery*, Volume 2, DAC Guidelines and Reference Series, OECD (2005).

Critical capacity questions to pose during the planning and design phase

- To what extent do the PFM organisations have staff with sufficient skills to lead and participate in diagnostic work and reform planning? What could be done to remedy the situation? To what extent can the PFM organisations influence the provision of skills in an adequate manner (in relation to, for example, the Civil Service Commission)?
- What is the individual capacity to critically examine results of diagnostic work and to involve other stakeholders than MoF? What skills development measures could be undertaken to facilitate active stakeholder involvement?
- What capacity exists to lead and manage the planning process, from the design of overall strategy to the preparation of work programmes? What can be done to overcome capacity constraints?
- What capacity exists to lead the work in designing the aid modality and the performance management framework for the reform programme? What can be done to overcome capacity constraints?
- What incentives are in place to enhance willingness to become involved and to maintain commitment to the reform? What strategies exist to ensure a continuation of reform, even if there should be a change in the political administration?
- What needs to be done to deal with resistance to reforms and to avoid a situation with “losers” from the reform who reject desired changes?

Critical capacity questions to pose regarding the implementation phase

- To what extent have the managers of key departments, likely to be responsible for reform implementation, the capacity, resources and competence to lead such work in their respective areas?
- Is the structure and mandate of the different PFM departments and managers clear (planning, accounting, budgeting, HR etc), both in terms of regular duties and in terms of PFM reform?
- Are there sufficient numbers of professionals with adequate skills that can devote sufficient time to give instructions and training in new systems and regulations?
- Have plans been made to revise financial regulations, prepare handbooks, instructional material and training programmes to facilitate reform implementation? To what extent is support available for making these materials user-friendly (rather than merely compilations of the new law and regulations)?
- Is the implementation strategy concerned with human resource development needs and are those needs allowed to influence sequencing and pace of implementation?
- Have adequate measures identified to prepare the staff concerned for the reform and have sufficient resources been allocated? Is there need to engage the Public Service Commission?
- Have adequate measures been taken to engage ministries and local authorities in developing the skills of their own staff to facilitate reform implementation?
- Have measures been taken to secure the long-term supply of accountants and financial management professionals?

Consistency between different laws and regulations may also be an issue to consider in the PFM reform. Sometimes, the reform programme includes the establishment of a specific legal framework component to ensure that the legislation is consistent. Unfortunately, reform efforts have often been driven by external partners, and concepts and definitions often differ among consultants/agencies and over time. To avoid inconsistencies and misunderstandings resulting from fragmented legal initiatives, it is important that legislative reforms are correctly sequenced and government-led. This is facilitated by clear responsibilities for coordination

In many cases reform work could advance through the introduction of new procedures that are – for an interim period – not defined as formal changes that should trigger new legislation. Such new procedures could be introduced in parallel to proposals for new legislation: making it possible in practice to move forward prior to the formal approval of the new law. In other cases, legislation is the driving force behind reform and few initiatives are introduced without the legal base being established prior to the change of systems and procedures. This often makes it important to start working on necessary amendments to the legal framework at early stages in the reform process.

7.3 Revision of the Overall Organisational Set-up and Application of Functional Reviews

The PFM organisational set-up differs from country to country. PFM reform may include efforts to merge institutions such as ministries of planning and finance, establish an independent external audit office, institute a supervisory function for procurement, or establish an office for IT support and systems operation.

Some of the reforms have the effect that manual work processes are changed through computerisation. This, in turn, may lead to considerable gains in processing time and access to reports and data, but may also lead to rationalisation and redundancies.

Early identification of such issues and their inclusion in the programme design is essential. There are techniques for so-called **functional reviews that analyse the functions of an organisation, identify bottlenecks, and determine solutions and opportunities.** These reviews usually result in new streamlined work processes, and needs to restructure departments and work units and to make changes in the number and composition of posts and job descriptions. The powers to decide on new organisational structures and staffing are, in most countries, vested in a public administration ministry or civil service commission. Therefore, it is important to involve such a government function in the functional reviews in order to gain acceptance and support for organisational changes. In cases where major redundancies can be expected, it is important to plan for retraining and redeployment and also to secure government support for necessary retrenchment of staff.

In some cases, the PFM reform can also offer an excellent opportunity to change or clarify roles related to PFM tasks at sector ministry or agency level. **PFM sometimes malfunctions, largely due to an unclear mandate and division of responsibilities between departments and/or government organisations,** or the separation of responsibilities that should be integrated or coordinated (e.g. planning and budgeting). Ideally, the PFM reform working group at the MoF, as well as at sector ministry/agency level, should include all different actors concerned and can facilitate clarification and

improvement in these matters, including coordination mechanisms where it is not possible to introduce changes to organisational structures.

7.4 A New Role for the MoF

A PFM reform will normally need to include the evolution and clarification of roles in the PFM system. The roles and functions of both central key institutions such as the ministry of finance, the ministry of planning and development (where there is one), the supreme audit institution and the revenue authority need clarification and revision in light of the new systems, as well as when authority is increasingly delegated to spending units.

The MoF will need to combine its responsibility for central supervision and its role as a custodian of norms and formats related to the national budget and accounting with the role of a service organisation. Examples of important services include responsibility for predictable budget releases, the development of a reliable IFMIS system (see below) that can deliver management information to all levels, provision of in-service training, guidelines, and information to support service delivery levels and functions.

Redefinition of the responsibilities of the MoF and other entities as a component of PFM reform also brings up the issue of deconcentration and decentralisation. From a SWAp perspective, it is crucial that line ministries are given authority to manage their own financial resources, and from a perspective of service delivery, it is normally equally important that local level administrations are given some level of financial autonomy. All these issues should be discussed during the revision of the mandate of central entities such as the MoF.

7.5 The Role of Sector Ministries in PFM Reform

Many, if not most, of the reforms in a PFM reform programme will need to be implemented not just at the MoF and ministry of planning, but throughout the public service – both horizontally by sector ministries and vertically by other levels of government such as agencies, regional and district offices, local government, and institutions such as schools and hospitals.

This is, for example, the case for budget ceilings that will need to be broken down from sector level downwards, the introduction of additional accounting and code structures and principles; the computerisation of accounting, payments, and the payroll system; the application of new procurement procedures and institutional arrangements; internal audit methods etc.

For some of the reform elements, the application is fairly standardised and the roll-out will need to involve information from the centre on new procedures and legislation, training of staff, setting up of suitable institutional arrangements and application of the new methods. Procurement could be one example of this and the implementation of a computerised pension system another. However, where procurement is concerned, there may be a need to investigate what the regulations imply in specific cases – for example for the procurement of pharmaceuticals in the health sector.

Other elements of reform will need adaptation to local situations and needs.

The roll-out of the IFMIS system and the introduction of multiple codes for accounting and financial statistics is one example of this. Each ministry and institution will need to analyse its own information needs, adjust the code structures to fit the organisation's

institutional division and budgetary responsibilities, its programmes and purpose structure, and its sources of financing. For an IFMIS roll-out, it will also be necessary to consider how to include portions of sectors that may not yet be computerised and how monthly/quarterly, manually kept accounts can be incorporated into, and reconciled with, the computerised system. Also, the pace of roll-out of different modules and functions in IFMIS will necessitate individual and sector implementation plans adapted to the circumstances on the ground. In addition, line ministries may need their own PFM reform programme (closely coordinated with the overall PFM reform plan) to tackle issues of disbursement of funds, delegation etc. **Sector PFM studies can be a useful complement to central diagnoses and identify bottlenecks and changes that can and need to be implemented at sector level and institutions.** There may well be a need for a health sector PFM reform effort as part of a health sector plan.

The PFM reform planning is therefore, by necessity, a dual responsibility between the central reform managers and line ministries. In many cases, the central reform plan and budget will not cater for all the needs of a sector in terms of training, equipment etc, but only for the central support provided. In addition, the line ministries need to prepare further plans and budgets to cover the sector needs for the full roll-out and implementation of new reforms and systems. For the sectors to be able to meet their own needs for the structure and design of different PFM systems, they must be allowed to participate as equally respected parties in the group that, in practical and technical terms, designs and presents proposals for the technical structure of different PFM functions, as part of, or independently of, the IFMIS system. For this, the sector may need advisory support and training to be able to fulfil its role. PFM systems are to be designed primarily to service the needs of the sectors.

Sida can play an important role in supporting participation and a strengthened role for line ministries in the reform programmes. Sida can also include PFM reform issues in sector support to line ministries.

7.6 The Issue of the Introduction and Use of the IFMIS⁴⁰

Computerisation of public finance management processes is a high priority component in PFM reform plans in many countries. The benefits of an *Integrated Financial Management Information System* (IFMIS) include the following:

- it gives many users simultaneous access to financial data and to the registration tool;
- it facilitates accurate and quick registration of data.;
- it can have some in-built control functions – once data is entered it cannot easily be tampered with and the system normally provides a tool to trace the data entry point and person;
- it allows multidimensional coding of transactions, enabling more diverse and less laborious reporting for analytical purposes;
- modern systems use queries or questions that, for example, can trace a certain amount or all invoices paid to a certain supplier;
- the systems have the capacity to process large amounts of data in very little time;

⁴⁰ *Integrated Financial Management Information Systems.*

- the systems allow for integration of different sub-databases for suppliers, clients, inventory, debt, payroll and payments, thereby facilitating control, and ensure that payments or other data are coherent and reduce the need for double registration;
- it can provide historical data and other tools to prepare the budget;
- it can register financial decisions at an early stage, commitment control, for better budget control;
- it provides better opportunities for budget execution and the introduction of a single treasury account.

There are, however, also disadvantages/issues important to consider:

- the computerisation of key processes such as PFM is a sensitive operation; if it is not successful it can harm PFM functionality and operation;
- it is a considerable investment and can lead to high annual license fees for users;
- it calls for infrastructure, capacity, electricity, connectivity, a safe operational environment (temperature, power back-up, communications) that may be costly and difficult to establish;
- in an environment that is not used to computers it creates dependency on experts and the risk of alienation and a loss of control;
- in environments with weak databases and information structures, financial information that is produced by these computerised processes is often overvalued in terms of reliability;
- the introduction of a broad-based IFMIS system often represents more information than can be handled by the government and diverts resources working with the improvement of more urgent areas (in accordance with the “basics right” concept);
- computerisation does not automatically resolve the problem of lack of overview of the PFM system or understanding of its purpose. Nor does it automatically increase the quality of information in the system.

Many of the good practices advocated indirectly through the “A” rating levels in the PEFA assessment necessitate, or are at least facilitated by, computerisation.

Commitment control, timely access to data, a good control environment and reporting on a number of dimensions – functional, administrative and financial, are examples of this. Experience in Sweden has shown that computerisation made it possible to implement reforms such as the single treasury account, multidimensional reporting, accrual accounting etc. The main benefit may, however, still be that the spending authorities with adequately skilled staff can operate with a high degree of financial delegation and accountability and that financial data for management decisions is instantly available.

Depending on the IT literacy level and the time frame of the IFMIS roll-out, it might be worthwhile to move ahead with general IT training at sub-national and sector levels, with the purpose of paving the way for the subsequent IFMIS roll-out at these levels. It might also be advantageous to allow the sub-national levels and sector departments to move ahead with computerisation of certain PFM functions (naturally without major investments in parallel systems) while waiting for the central reform to materialise, as a way of increasing the understanding of what computerisation of PFM functions means, as well as to reduce resistance in relation to the IFMIS reform. For instance, the

Some experience gained from the computerisation of PFM functions:

- Computerisation of accounting systems is, in most cases, an advantage, but can start with simpler functions and the core database of transactions and accounts – the general ledger. This could include computerisation of the payment system
- Computerisation can be combined with lower level manual accounts as aggregate periodic records from local institutions can be coded and captured in the computerised system. Computerisation at lower levels can often be solved through technically simpler hardware and software systems
- Accrual accounting is a useful but quite advanced concept: most countries need to start getting their cash accounting in place first.
- The IT support structure needs to be investigated and put in place when automation is considered.
- Integration of computerised accounting systems and pay-roll systems is important as the payroll represents a substantial part of the budget and of payments. The same could be said for a commitment control system including both regular budget commitments and commitments to state-owned enterprises.
- Inclusion of the planning and budget process in the IFMIS system may, however, be considered less important compared to the registration of reconciled accounts, a well functioning commitment control system, and integration of the procurement and payroll system.

use of Excel spread sheets in the budgeting process might be one way of paving the way for understanding the multi-dimensional budget classifications formats that may form a part of the IFMIS.

Experience of IFMIS reform in a number of African countries also concludes that, in the choice between standard and bespoke systems, the choice of standard “off-the-shelf” systems is more likely to facilitate the effective integration of the needs of sub-national levels concerning the interface with other management information systems, as well as, in general, be more cost-efficient than bespoke systems.

7.7 Corruption

The misuse of public funds is a risk factor in the management of any public sector. Initial questions to pose in the preparation of support to reform activities are:⁴¹

- To what degree is corruption established in different institutions? Is it a direct threat to poverty reduction programmes?
- How committed is government to strengthening governance and tackling corruption, and does it have a track record of progress or failure?

Many different factors in government institutions will determine the level of corruption. Risk factors include unclear roles and positions for civil servants, low salaries for publicly employed staff, weak control of sector implementing procedures, weak control of local level activities, and poor PFM systems. A PFM reform is one of the most essential instruments in the fight against corruption.

⁴¹ From the *World Bank Corruption Paper*, August 2006.

There are a number of PFM-related procedures that can lead to a greater risk of corruptive behaviour than otherwise. These are largely related to weak accounting and reporting systems and the handling of cash. Special areas to note:

- Procurement
- All handling of cash in the distribution of expenditure resources and revenue collection (e.g. taxes) such as custom fees or service fees
- The cash flow of external funds. Are they registered in the budget? Is everything registered or just part of it?
- Payroll registration and disbursement of salaries
- Uneven, infrequent or uncommon events with public cash flow: for example privatisation of state enterprises; collection of concession fees; uncommon or uneven payments of debts; or approval of new loans

Some examples of corruption risks linked to PFM systems:

- Biased planning (to certain regions, expenditure areas)
- Skewed or unrealistic budgeting for the purpose of misuse of funds
- Off-budget resources not subject to public control
- Poor or no financial reporting of expenditure and revenue
- Inaccurate distribution of funds in relation to allocations
- Weak procurement processes
- Leaking payment systems
- No reconciliation of accounts
- Weak control of domestic revenue
- Weak audit and supervisory functions
- Lack of accountability control by parties outside the government
- Lack of sanctions when misuse has been confirmed
- No institutionalised follow-up procedures for results

The special issue of corruption and programme support is highlighted in *Sida's Anti-corruption Regulation* and has been touched on in previous sections of this part of the handbook. Apart from fungibility⁴², the introduction of a large number of individual donor project bank accounts and disbursement procedures linked to projects constitutes in itself a severe risk for misuse of funds compared to the channelling of all funds through one system, i.e. the government's system. Utilising the government's systems also open up an opportunity to improve the PFM system and hence address corruption in a sustainable way. Weak spots in the PFM system should have been identified in PFM assessments, including ways of managing risk (cf chapter 2).

The *Joint Financing Agreements* (JFAs – see chapter 4 in this handbook) play an important role in the fight against corruption. The templates for JFAs signed by Sida (as a member of the Nordic + group) present good opportunities to follow up both financial flows and results.

⁴² For a definition of fungibility see Appendix 1.

A *PFM reform* can seek to reduce the risks of corruption and embezzlement through:

- Promotion of a comprehensive budget.
- Introduction of a transparent budget process.
- Implementation of new procurement legislation, processes and institutional arrangements.
- Improved tax and customs registration, administration and organisation.
- Introduction of new payroll, commitment control, procurement and pension systems, and efforts to integrate these with the IFMIS system for improved control.
- Accurate and timely reporting to budget-holders, the audit agency and the general public from the IFMIS system, combined with improved functions for compilation of specific reports for control and audit purposes.
- Introduction of risk-based audit.
- Improved control and registration of external funding that is subject to the same control environment as the government's funds in the budget.
- Promotion of a participatory budget process with institutionalised engagement from end-receivers of budget funds (importantly from local levels).

There are a number of international diagnostic instruments which relate to corruption, for example:

- *Institutional and Governance Reviews (IGR)*, World Bank
- *Country Procurement Assessment Reviews (CPAR)*, World Bank
- *Fiduciary Risk Assessments*, DFID
- PEFA diagnostics, PEFA Secretariat

The *U4 Anti Corruption Resource Centre* provides different kinds of resources for anti-corruption purposes including a project database, a link portal, a helpdesk and anti-corruption training.⁴³

7.8 Oversight – the Role of Parliament and External Audit

Parliamentary oversight over government activities is an important part of the accountability process in the PFM system. Parliament is the legislative body that approves the annual state budget. Effective parliamentary scrutiny provides an element of demand for information on how government has used the public resources. Parliament exercises this oversight through the work of specialised committees.

The external audit – carried out by the **Supreme Audit Institution (SAI)** – **contributes to this oversight function by providing independent audit reports on the execution of the state budget by government and the budget users.** The SAI normally reports to parliament, but reports should also be available to the general public, thereby contributing to the public debate on how the government spends public resources.

A well-performing SAI audits the legality and regularity of financial management and of accounting as well as the performance, economy, efficiency and effectiveness of

⁴³<http://partner.U4.no>.

the public administration. In doing so, the SAI provides information on whether public resources are properly accounted for and used for their intended purposes, as well as on whether government activities provide value for money and to what extent policy objectives are reached. The SAI hereby acquires a good overview of state activities and an insight into how state organisations function and their capacity, or lack of capacity, to perform their tasks. With this information, the SAI can be an active role-player in the overall development of the PFM system.

Few SAIs perform according to this ideal. The need of support for capacity development is equally important for external audit as for other parts of the PFM system in developing countries. Capacity constraints for SAIs include scarce resources, inadequate staff skills, lack of adherence to international auditing standards, and weak communication of audit findings. There are also often doubts as to whether a SAI is as independent as it should be. A common problem is that the legal framework is not up to international standards when it comes to safeguarding the independence of the audit office.

In the interim, development partners may need to apply their own external audit but, in the long run, ownership of the budget process is best promoted by supporting the partner country's own control mechanisms, including both internal and external audit.

When considering support to the reform of external audit, it is equally important not to forget the parliamentary committee(s) responsible for audit. In order for the audit findings to have an impact in the form of changed behaviour in government, it is crucial that parliament is active in holding government accountable. There is generally limited capacity in parliament for doing this. In many countries, a lack of understanding of the concepts of modern financial management applies also to members of parliament, and the parliamentary committees do not often have regulations and guidelines on how to deal with audit reports. Secretariat functions in parliament and its special committees normally have severe capacity constraints.

The desired situation is that the findings of the external audit lead to measures being taken by government and the audited institutions in order to correct unintended behaviour or malpractices. This is far from always the case.

Parliamentary scrutiny should include strong supervision of government's reactions to audit findings. Ideally, parliament reaches its own conclusions on the issues raised in audit reports and other findings, often after arranging hearings with responsible ministers and/or financial managers. In many countries, there are provisions in the organic budget legislation requiring government and individual budget institutions to comment on the external audit findings and report on ways deficiencies will be addressed.

As can be seen in other parts of this handbook, most diagnostic studies carried out in the field of PFM cover assessments of the performance of the external audit as well as that of the parliamentary committees responsible for audit. Such assessments can be used as a first indicator of the need to provide support to these actors.

Bearing in mind the independent position of SAIs, it is problematic to include support to external audit in the overall financing modality of PFM reform. **In principle, the SAI should not be placed in a situation where it becomes dependent on funds that are handled by an authority under government** (which, in turn, it will be auditing). The same, of course, applies to the parliamentary committees in need of support for capacity development. For reforms in these areas it is therefore necessary to consider

creating separate reform projects, either in the form of direct project support to each institution or through a separate basket-funding arrangement for the institutions concerned.

Riksrevisionen – the *Swedish National Audit Office* (SNAO) – receives a special appropriation from parliament in the Swedish budget for international development cooperation to undertake institutional cooperation with SAIs in developing countries. Even though the SNAO's work is important for external audit in many countries, it can only cover a limited number of developing countries.

Even when the external audit institution and parliament are supported separately from overall PFM funds, it is highly important that their development is closely coordinated with other reform initiatives in the PFM area. This can be done by including these actors in PFM reporting schemes and making sure they regularly participate – independently – in ongoing coordination of these reforms.

In practical capacity development activities such as training, there should be good opportunities to coordinate and harmonise activities between several actors, for example for basic training in accounting and reporting, training in financial management, internal controls, IFMIS etc.

When it comes to reforms of the legal framework in the PFM area generally and for audit specifically, there are strong reasons for very close coordination between different initiatives. All actors in the system need to have a clear perception of their role and responsibilities in relation to others and the expectations that other actors have on them. See further section 6.2: *Reform of the legal framework*.

8 Fiscal Decentralisation and Local Influence on PFM

The purpose of this chapter is to present ways in which PFM systems could allow for an adequate level of fiscal decentralisation and local influence over the allocation and usage of public resources. It also presents the concept, challenges faced, and some suggestions for approaches to fiscal decentralisation in development cooperation.

In this chapter you can read about:

- **Key elements linked to fiscal decentralisation**
- **How to handle PFM problems in this area**
- **Issues for Sida to consider**

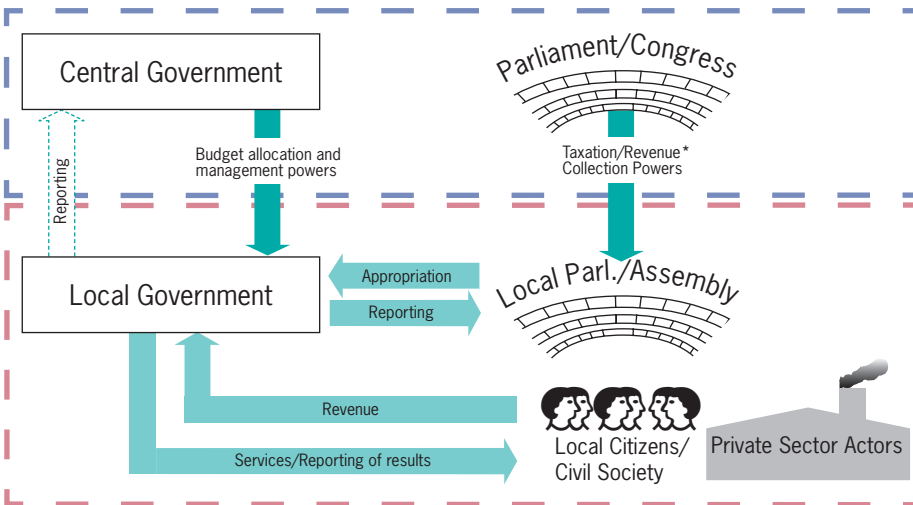
8.1 Introduction of Key Elements

8.1.1 Definitions

Fiscal decentralisation can be defined as the “transfer of funds and/or revenue-raising powers from higher levels to lower levels in political systems (which include both administrative structures and elected bodies)⁴⁴. Fiscal decentralisation is often considered one of three types of decentralisation, namely:

- a) **Fiscal decentralisation;**
- b) **Administrative decentralisation** (deconcentration/delegation/devolution), i.e. the transfer of administrative powers, and sometimes administrative personnel, from higher to lower levels in the political system; and
- c) **Democratic decentralisation:** The transfer of resources (including financial and administrative resources) and powers (including decision-making powers, and sometimes revenue-raising powers) from higher levels in political systems to elected bodies at lower levels

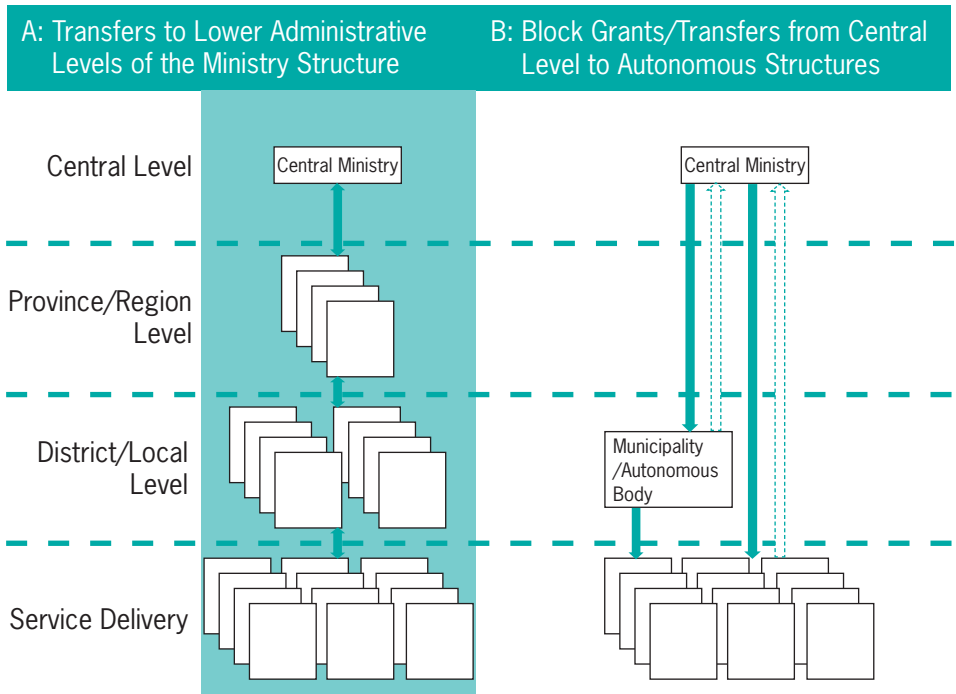
Fiscal Decentralisation



* Normally only covers a part of the local government revenue.

⁴⁴ Manor, James; *Local Governance*, Institute of Development Studies, University of Sussex, 2006.

Two Models for Transfer of Funds



Key Features

- The ministry structure includes all administrative levels, including Service Delivery units
- Financial reporting is due based on transfers
- Note: The vertical allocation of funds often collide with the horizontal allocation decision.

Key Features

- Service delivery is the responsibility of autonomous bodies which are dependent on transfers from central level for its operations
- Financial reporting is not done specifically on the grants, but in an overall financial report covering all income and expenditure of the autonomous body.

Boex⁴⁵ lists the following four “pillars” (interrelated dimensions) into which fiscal decentralisation can be divided. They are (in sequencing order):

1. **Assignment of expenditure responsibilities** (i.e. responsibility for managing expenditure, which should be linked to the functions to be performed at that level);
2. **Assignment of revenue sources** (given the expenditure responsibilities: what tax and non-tax revenue resources will be made available to the sub-national government to provide it with resources?);
3. **Intergovernmental fiscal transfers** (in addition to assigning its own revenue sources, the central government may provide regional/local governments with additional resources through a system of intergovernmental fiscal transfers or grants). Transfers can be conditional (targeted) or unconditional; they can come as block grants or as reimbursements of actual expenditure, or they can match, in some proportion, local government expenditures. They can also come in the form of revenue-sharing from central government;

⁴⁵ Boex, Jamie. *An introductory overview of intergovernmental fiscal relations*. International studies program. Georgia State University, 2001.

4. **Sub-national deficits and sub-national debt** (authorisation of municipal borrowing and mobilisation of national or local government resources through, for example, loan guarantees).

This handbook will mainly provide guidance in relation to categories 1 and 3.

Table 8.1 Overview of Fiscal Decentralisation Arrangements

Responsibility and autonomy at local level for PFM functions	Revenue sources at local level ⁴⁶				
	Intergovernmental transfers ⁴⁷			Local sources of revenue	
	Conditional grants	Block grants	Revenue sharing (with central level)	Assignment of revenue sources	Authority to incur debt/deficits at sub-national level
Level of discretion of planning and budgeting	Low	High	High/Low ⁴⁸	High/Low ⁴⁹	High ⁵⁰
Level of discretion over management of funds (payments and accounting)	Low	High	High/Low	High	High
Financial reporting/accountability	Report to central level according to central standards	Part of local level annual financial report	Depends, but often report to central level according to central standards	Part of local level annual financial report	Often part of national monitoring system
Scrutiny/Audit	Central audit by SAI and internal audit department	Depends. Often central audit by SAI, combined with local audit requirements	Often central audit by SAI and internal audit department	Audit mainly a local responsibility. Often also audit by SAI	Often part of national audit

⁴⁶ In practice the total revenue picture of a local authority or administration is composed of a combination of the above-mentioned sources.

⁴⁷ Regular budget allocations for administrative functions at local level are often/normally included as either conditional grants or block grants.

⁴⁸ Revenue sharing means that certain revenue controlled at central level is shared with the local level, e.g. the municipalities in a country receive x% of the total VAT revenues collected by the central authorities.

⁴⁹ Assignment of revenue sources means that the authority over certain types of taxes/fees is given/transferred to the sub-national level. Even if a local authority has been assigned revenue resources, these normally only constitute a fraction of its total resources. The major taxes and fees normally continue to be raised at central level.

⁵⁰ This authority is often restricted due to its possible negative macroeconomic implications. It is often, for example, part of legislation that sub-national level administration must balance its budget.

From the above-listed definitions, it follows that fiscal decentralisation should be considered an integral part of decentralisation as such. Provided that the necessary conditions are at hand, fiscal decentralisation can be a way of, and is often a prerequisite for, enhancing the efficient allocation and use of resources at the local level. Some of these conditions include the following⁵¹:

1. The decentralisation framework should ideally link local financing and fiscal authority to the service provision responsibilities and functions of local government, so that local politicians can deliver on their promises and bear the costs of their decisions.
2. Local communities must be informed about the costs of services and delivery options and the resource envelope and its sources, so that the decisions they make are meaningful. Participatory budgeting is one way to create this condition.
3. Communities need a mechanism for expressing their preferences in a way that is binding on politicians, so that there is a credible incentive for people to participate.
4. There must be a system of accountability based on public and transparent information that enables communities to monitor the performance of local government effectively and to react appropriately to that performance, so that politicians and local officials have an incentive to be responsive.
5. The instruments of decentralisation – the legal and institutional framework, the structure of service delivery responsibilities, and the intergovernmental fiscal system – must be designed to support the political objectives.
6. The mandate and capacity to plan, follow-up and account for resources based on this mandate need to exist at the local level.
7. In the cases where local government is dependent on fiscal transfers, the predictability of these transfers is essential for decentralisation to work.
8. There needs to be a balance between central level direction (regulation) and local discretion over the use of resources.
9. There needs to be capacity at the central level to monitor and support the fiscal decentralisation process at the local level.
10. External conditions must be favourable at the local level (e.g. reasonably functioning markets, communications, banking infrastructure etc.).

8.1.2 Fiscal Decentralisation – Always a Positive Thing?

The rationale for fiscal decentralisation is that elected and administrative officials in the local government/administration should, provided the capacity is installed, be the most qualified to make decisions on the allocation and management of resources.

Fiscal decentralisation is, however, not automatically a good thing. It will not automatically improve the efficiency of spending or service delivery, nor ensure a greater poverty focus in spending patterns. Funds spent locally are not automatically spent more efficiently or with more participation from different interest groups. Audit and other control functions are also sometimes not so easy to perform at the local level.

Decentralisation guarantees neither local participation nor accountability of local

⁵¹ Boex, Jamie. *An introductory overview of intergovernmental fiscal relations*. International studies program. Georgia State University. 2001. Litvack et al (editor), *Decentralisation briefing notes*. World Bank Institute (1999).

governments to their residents. All these aspects need to be carefully considered when embarking on a decentralisation process. For fiscal decentralisation to contribute to these objectives, central level government must have the capacity to support the local level administration in the process. Hence, **it is essential to both develop the capacity of local governments, and the abilities of central government officials to assist local governments in the process of their evolution to greater autonomy.** Further, fiscal powers should not be decentralized due to decentralisation being in vogue in the development partner community. Decentralisation must carry a clear, nationally-owned purpose such as improved efficiency, poverty reduction and/or democratic development.

In many developing countries, financial management is highly centralised and local influence over allocation and spending decisions, as well as the actual management of funds, is limited. SWAPs sometimes tend to strengthen this tendency even further, since a SWAp is a planning tool which promotes central coordination of the whole planning and budgeting cycle, and the centralisation of allocation of resources to one focal point at the central level. In many contexts this tends, at least initially in the process, to decrease the scope for focusing on decentralised levels and their ability to both manage resources and to deliver results. Additionally, the logic of the SWAp – covering an entire sector – tends to enhance a vertical focus on planning and resource management, which sometimes, at the local level, contradicts planning with a horizontal focus (across policy areas) for a certain territory. However, a SWAp in itself does not necessarily have to work against fiscal decentralisation ambitions, provided this perspective is raised and promoted within the framework of the sector coordination.

For a SWAp to work in relation to decentralised structures, it is essential that the sector works with planning instruments that are also consistent and applicable at decentralised level; i.e. adjusted to local conditions (which is one of the points of fiscal decentralisation, i.e. to better adapt spending to local conditions). It is further important that the budgeting process allows for sufficient time to include the planning and follow-up process at decentralised levels. The dialogue on sector priorities and reform initiatives should also include representatives of the decentralised levels (whether politically decentralised or merely deconcentrated), in order to ensure their perspective and that their perception of the sector's challenges is reflected in the plans and budgets. Development partners hence need to raise this perspective in the dialogue with the sector.

Fiscal decentralisation can take on very different forms. In some cases, planning, budgeting and programming is decentralised, whereas actual funds management (including procurement, contracting and accounting) continues to be managed by the central level. In other cases, both the budgeting and management of funds are decentralised to the local level. In yet other cases, certain authorities are completely autonomous, or semi-autonomous, and only receive block grants/transfers from the central level, which often implies few – or no – obligations, and they are sometimes not even required to report back on the spending of these resources. Finally, there are aspects linked to decentralisation of the PFM mandate/authority powers that are important to consider, whether between or within (i.e. delegation) the same administrative unit/level. One such issue is the real power of budget holders, i.e. to what extent budget holders at different levels/departments have the mandate to manage their own budget, for instance regarding in-year budget reallocation without previous authorisation from a superior level.

Other aspects important to consider when dealing with fiscal decentralisation include the position of different regions, the level of autonomy of the local authorities, the coordination of horizontal and vertical resource allocation, and the relevance and transparency of the criteria for resource allocation. Local conditions for effective budget execution should also be included in this analysis.

Fiscal decentralisation can also potentially be a way of enhancing democratic governance, in the sense that it can help strengthen local accountability and participation in the planning and budgeting cycle. It can also be a way of balancing power between different political/administrative levels.

8.2 PFM Issues Related to Fiscal Decentralisation and How to Deal with these

Some key issues/problems regarding fiscal decentralisation linked to PFM conditions are listed below in the column on the left, and in the column on the right you will find some proposed measures for dealing with these issues. The examples mainly deal with government transfers and block grants.

Table 8.2

Issue/problem	Solutions and recommendations
<p>High uncertainty of actual access to funds (liquidity)</p> <p>Explanation: Can be due to a variety of reasons such as: (1) cumbersome processes for releasing funds from central level and/or low priority given to decentralised units (2) poor reporting mechanisms which affect replenishment of funds, (3) inefficient and limited banking network, (4) overall infrastructure situation which means accessing funds involves substantial travelling.</p>	<p>Support the central level in improving the systems for disbursements and reporting from decentralised level.</p> <p>Support the central level in the introduction and implementation of a payment system that can secure liquidity and the accurate transfer of funds to all authorities concerned.</p> <p>Monitor not only the budget allocations, but also the actual disbursements and timing of these, as part of annual/semi-annual reviews.</p> <p>Promote a dialogue on alternative solutions for flows of funds and PFM-related routines when infrastructure or other conditions are not in place.</p> <p>Introduce intermediate solutions of direct transfers of funds to decentralised levels (in combination with approval by and information to the MoF).</p>

Issue/problem	Solutions and recommendations
<p>Delayed/inadequate financial reporting on funds transferred to lower administrative levels from decentralised level</p> <p>This may be due to circumstances such as (1) human capacity constraints, (2) unclear regulations, (3) delays in feedback between the central and decentralised level management, and sometimes (4) communication challenges due to distances and lack of infrastructure.</p> <p>Often basic necessities such as accounts reconciliation are only performed with substantial delays, which is a serious constraint in terms of financial control.</p>	<p>On-the-job training and provision of user-friendly manuals that include the basics of PFM such as accounts reconciliation, accounting standards, procurement etc.</p> <p>Support the central level in improving its M&E system, including regular visits to local decentralised levels, and quality and timely feedback regarding its reporting.</p> <p>Support the internal audit department (possibly at the regional level) in improving its scrutiny of budget execution at decentralised levels.</p> <p>Support the introduction of simple software applications (off-the-shelf equipment) at local level to register the content in financial reports. Do not rush the introduction of a general IFMIS at decentralised level until conditions at both decentralised and central levels so permit.</p> <p>In cases of block grants, separate reports on these grants are normally not required. Instead, one should focus on improving financial and results statistics, as well as strengthening the functions for audit at decentralised levels.</p>
<p>Increased fiduciary risks at local level due to corrupt or nepotistic tendencies</p> <p>In smaller, “closed” environments family, ethnic or other solidarities may be stronger, and corruption risks greater due to non-frequency of follow-up and audit visits, poor routines for financial control and lack of human capacity and knowledge.</p>	<p>Same solutions as above, especially related to monitoring and internal audit.</p> <p>Support the establishment of transparency and accountability arrangements prior to embarking on fiscal decentralisation. One example of this could be public announcements of allocated amounts from the budget to the local level.</p>
<p>Lack of financial overview and accountability due multiple channels of allocation of funds</p> <p>The combination of horizontal and vertical allocation of funds according to different (non-coordinated) criteria, often implies that the local level has to manage multiple budgets in parallel, each according to a different regulative framework. This makes it difficult to maintain an overview of available resources and increases the risk of sub-optimising the use of resources.</p> <p>This situation often arises due to non-aligned/non-harmonised external support to the local level, which makes efficient management of resources difficult.</p> <p>Parliamentary oversight is also essential for domestic internal accountability in relation to funds allocated to the local level. This, however, presupposes that the funds are reported back timely and in a format that enhances and promotes accountability.</p>	<p>Encourage the development of a coherent national policy for overall resource allocation across and within sectors/institutions, as well as mechanisms for including resources allocated to decentralised levels in the national accounts and audits, and thereby the accountability process. The SWAp process in itself strengthens this process of co-ordination.</p> <p>Development partners providing funds to the decentralised levels, should be requested to provide information about these funds in accordance with the national and local planning and budgeting cycle, and should, to the best of their ability, use the same planning, budgeting and reporting formats, resource allocation criteria etc as those of the government. This should facilitate the national accountability of these funds.</p> <p>Encourage joint planning and budgeting exercises at local level, and set standards nationally (e.g. through the sector’s code of conduct) for external funding to decentralised levels.</p> <p>Encourage joint audit exercises between different sources of funding where possible. Risks created through the separation of funds can be highlighted, and proposals for the improvement of funds management developed.</p> <p>The SWAp process should strengthen all these aspects.</p>

Issue/problem	Solutions and recommendations
<p>Lack of dialogue between the decentralised level and the MoF/ other central ministries</p> <p>Just as sector ministries often need support to enhance their dialogue with the MoF, the decentralised levels may be in need of the same, both in relation to the MoF representatives at local level and to their Ministry headquarters.</p>	<p>Promote the inclusion of the decentralised levels in the national sector/PRS dialogue.</p> <p>Support the creation of mechanisms/forums for the dialogue between the local and central level.</p>
<p>Instruments for pro-poor budgeting should also exist in relation to decentralised levels</p> <p>The resource allocation criteria for different areas need to take into consideration the poverty and cost profile of these regions. Follow-up of this is important in relation to budget allocations, actual disbursements and final budget execution.</p>	<p>Ensure that the budget allocation criteria are based on conditions in each region (the budgeting system should allow for different cost and poverty profiles).</p> <p>Monitoring of actual budget distribution and execution at decentralised levels, based on agreed criteria, as part of annual reviews.</p>
<p>Non-controlled sub-national financial commitments with consequences for state finances</p> <p>Depending on the rights that decentralised levels have to incur financial commitments, for instance to borrow money, central treasury needs information on the current state of local commitments.</p>	<p>Review the functioning of the central level monitoring system for these kinds of commitments and, through dialogue/support, encourage clear rules for the authority of sub-national levels to incur liabilities/debt.</p> <p>Rules normally have to be changed through administrative processes at the central level, which could take a great deal of time.</p>
<p>Lack of local revenue collection control</p> <p>In many countries revenue collection takes place at the local level through a revenue administration with representation also at central level. The control/monitoring of revenue collection is often insufficient, and the regulations for the processing of these funds are often not clear enough, which may substantially delay budget execution. This, combined with delayed disbursements from central level, may create unnecessary temptation for the civil servants involved. In other cases, the demands on local revenue collection made by central level are unrealistic, which means that the local budget is left with a deficit.</p>	<p>Build capacity in the internal audit department to promote adequate revenue control.</p> <p>Ensure that guidelines for the usage of locally raised revenues are clear.</p> <p>Monitor the budget outcome (regarding the income side) against the revenue collection expectations communicated from central level (important from a poverty perspective) and raise unreasonable demands on local level revenue collection in the dialogue with the MoF/sector at central level.</p> <p>Introduce simple off-the-shelf software applications for registration of incoming revenue.</p> <p>Promote the publication of expected local revenue at the local level (e.g. public boards).</p>

Issue/problem	Solutions and recommendations
<p>Budget management regulations that hinder efficient spending of resources at local level</p> <p>For example, insufficient level of delegation of the mandate to budget holders to reallocate funds between budget items (cost items), or non-existence of deputies to sign in the absence of the budget holder.</p>	<p>Promote the delegation of authority over budget decisions to budget holders, including free reallocations of funds between cost/line items in the budget within programmes. This can, in some cases, be a precondition for decentralised support. It should preferably be combined with enhanced personal accountability, as well as local community accountability mechanisms.</p> <p>Delegation of financial management normally also has to be introduced at the central level and will take time.</p> <p>Encourage the assigning of deputies at local level, and the training of budget holders and deputies in PFM regulations and personal accountability.</p>
<p>Constitutional autonomy</p> <p>In contexts where local authorities have constitutional autonomy (e.g. with the exception of national legislation are completely independent of central government), but still receive transfers from central government, there are considerable variations in the extent to which these local authorities are obliged to report back on the grants/transfers received. In some cases important parts of the sector have this kind of autonomy.</p> <p>In many cases the way in which financial resources to these local authorities or institutions are shown in the state budget is just in the form of lump sum transfers. Hence, high levels of budget execution in relation to these entities may simply represent the transfer of these funds to the entities, rather than funds spent and properly accounted for.</p>	<p>Focus on development results in the sector to safeguard the poverty profile of resources spent.</p> <p>In some cases financial information for the whole sector could also be found at the central statistics office, e.g. through the national accounts. In some countries the central ministry still compiles information from all administrative levels into one comprehensive financial account.</p> <p>When doing budget follow-up in annual reviews, make sure that the figures presented on budget execution really correspond to and include all resources spent.</p>
<p>Participative budgeting and accountability control at decentralised level</p> <p>Local participation and insight into the budget process is important from a democratic perspective. However, it needs to be done in a pragmatic fashion, with a cost-benefit and sustainability perspective, where the choice of stakeholders considers perspectives of both representation and competence. Participation must not just be a formality, but provide a real opportunity to exert an influence.</p>	<p>Training and clear information should be provided to all participants, including purpose, realistic possibilities and processes.</p> <p>Participation is not enough. The opinions of the stakeholders need to be respected by both the local and central authorities, as well as external financiers (hence the mandate must be given for taking into account the participants' viewpoints). Any special conditions that apply to the outcome of the exercise must be clearly communicated beforehand.</p> <p>The involvement of the community in budgeting should not be restricted to the budgeting process, but should cover the whole budget cycle, i.e. budgeting, budget execution and follow-up/evaluation/audit.</p> <p>Finally, the process should ideally cover the overall budget of the area/sector, and not merely a small fraction of externally provided support, otherwise the bulk of funds may be decided upon without taking local opinions into consideration.</p> <p>The process following the consultations should be transparent, so that any changes made in relation to the agreed budget allocations after the participatory process are explained/justified.</p>

Issue/problem	Solutions and recommendations
<p>Parallel PFM and administrative decentralisation processes</p> <p>It is not uncommon that certain administrative processes, responsibilities and service delivery functions, are decentralised in parallel with fiscal decentralisation, each process being handled in isolation from the other. It is also not uncommon that the central level administration wants to devolve responsibilities to lower levels of administration, but not release its direct control of the funds for realising these activities.</p> <p>Some development partners may have a history of different forms of direct support to provinces, districts or service delivery units, trying to build capacity for future decentralisation, in which the local authority has gained some additional power due to the parallel access to additional external resources.</p>	<p>Support the integration of these two processes and the effective decentralisation of responsibilities and budget management jointly.</p> <p>Encourage initiatives that support the development of capacity at local authority level to manage funds, as well as in the central administration to constructively support this process at local level (through an M&E-system, internal audits, on-the-job training etc).</p> <p>Providing direct support to the local level may be risky, and not always in line with the intentions of the central authorities. Therefore, in these cases it might have serious implications for future resource allocations once a donor decides to join a common financial arrangement at central level instead of channelling funds directly to a certain local authority. Sida should therefore ensure that any ongoing or planned programmes of support to decentralised levels are in line with the national policy and, in terms of PFM, integrated as much as possible with the regular PFM systems of the government, including the budget process and resource allocation criteria.</p>
<p>Unequal resource allocation between different regions/areas (for example urban vs. rural areas)</p> <p>Due to historical, political, or conflict reasons, or lack of influence of certain regions/areas, resource allocation may be unequal between different regions. In many contexts it is not unusual that urban areas are privileged in comparison to rural areas. With an incremental budgeting process this situation is likely to prevail.</p> <p>(These recommendations are less valid for block grant systems, where criteria for resource allocation based on living conditions, demographic criteria etc. are applied).</p>	<p>In the dialogue with central government, Sida should raise these concerns, request information on the basis for the current distribution of funds, and promote distribution of resources that is in accordance with current poverty reduction/development plans. It is then essential that the financial information provided can be presented both in a programmatic format and based on different administrative levels and geographical areas. Maps (if available) combining geographical, demographic, infrastructural and financial information can, in this respect, be a very powerful tool to use when discussing resource allocations.</p> <p>Investment budget distributions should also be based on objective criteria such as the current service delivery network, including service delivery staff and existing functioning infrastructure (wells, health centres, primary schools), population etc.</p> <p>Since much of the expenditure in many of the social sectors is salaries, it is important that this perspective is also made visible in the overall resource allocation analysis, even if these resources are managed at central level and under a specific budget line.</p>
<p>Actual disbursement of funds not in accordance with budget allocations</p> <p>In many cases actual disbursements and distribution of resources to the local level, as well as to service delivery units, do not correspond to resources decided on in the budget.</p>	<p>This problem could be reduced by introducing an open and public accountability process at the local level, such as announcement of the amount of money that has been allocated in the budget for the local level, to schools and clinics etc.</p> <p>Monitor this development, including the timing of disbursements, (at all levels) and raise the issue with the central level government authorities at an adequate level (depending on the cooperation structure).</p>

Issue/problem	Solutions and recommendations
<p>Rapid IFMIS – roll-out or over-optimism regarding what IS-systems will be able to accomplish at decentralised levels</p>	<p>An IFMIS roll-out should normally start at the centre. It is essential that this process is allowed to take the time it needs, and is adapted to the technological, human and infrastructure conditions at each place and level.</p> <p>As a rule of thumb an IFMIS (or any other IS/IT system) does not in itself solve problems of accountability, timeliness of expenditure returns etc, which are due to cumbersome (sometimes over-regulated) processes. This is done through independent administrative processes that have the aim of changing regulations. Hence, Sida should not push for a rapid roll-out of these systems when conditions are not in place. It is better to stick to a manual system, and make slight improvements to the accountability mechanisms, rather than to push for an overnight roll-out of fully fledged and complex computerised accounting systems in districts/local administrations that are not ready for it.</p> <p>As a role of thumb, in order to cover their needs, local level administrations should almost always introduce much simpler computerised financial management systems than the central IFMIS.</p>
<p>Central budget process not adapted to local needs and conditions</p>	<p>In cases where local authorities are part of the central budget process, it is essential that this process allows sufficient time for planning and budgeting for these levels, and that the local authorities are informed about their expenditure ceilings, as well as all intended steps in the entire budget process, well in advance.</p> <p>There is a need for mechanisms and time for a dialogue to take place between the central and local level on resource allocation in relation to the plans of the local level (at best through a MTEF process). The presentation of reports, in the same format as the central level, is another important aspect for the consolidation of accounts. Sida should promote consideration of all of these aspects in relation to decentralized units, whether it provides financial support directly to these entities, or indirectly through SPS or GBS.</p>

8.3 General Recommendations

- In cases of constitutional autonomy, consider special conditionality (jointly with other development partners) in relation to the accountability of authorities receiving state grants. Try also to influence the overall system for resource distribution to ensure that it is in line with the national poverty reduction strategy. This could be done through the development and follow-up of result indicators.
- Ensure that the programme of support contributes to a budget management cycle at each level that is as coherent and unified as possible. It should ideally provide funds at central level, with resource allocation criteria for the local level clearly defined. The SWAp processes could be used to promote these objectives.
- Encourage the integration of administrative and fiscal decentralisation as two sides of the same coin.

- Be cautious regarding the continuation or start-up of direct (project) support to decentralised levels, since this may mean redirection of internal funds from these local authority units to others not receiving external funding. Ensure that all support to the local level is coherent with an overall decentralisation and resource allocation policy.
- In cases when central authorities are unable to provide funds for decentralised levels, consider – in collaboration with both the central and local administration – the interim disbursement of development partner funds directly to the local level (if possible as budget support). However, this must then be designed in a way that does not undermine government ownership, allocative efficiency or the long-term funding situation of a certain region/local authority.
- If external funds are directly disbursed to decentralised levels, provide information about these funds to the ministry at central level in accordance with the national and local planning and budgeting cycle. The support provided should naturally be coherent with the overall government policy in the area.
- Monitor (and raise as a dialogue issue) the geographical and poverty-based distribution of funds, and promote a distribution of resources in accordance with current poverty indices and plans. This requires a budgeting and accounting structure that allows for reporting based on these parameters.
- Promote the introduction of safeguard mechanisms that will guarantee the actual allocation of resources decided in the state budget to the local level. This could be done, for example, through accountability processes where budget allocations to local level structures are made public at the local level and where actual disbursements of the corresponding amounts are monitored and followed-up by local authorities
- Promote and include local level aspects in the planning process in the SWAp. This could be done through the inclusion of local level representatives in the formulation process, and technically by adjusting planning and budgeting instruments to suit local needs.

Appendix 1 Earmarking, Fungibility and Additionality

Earmarking can be defined as the tying of support to the financing of pre-specified areas/items within the State Budget. The intention is that, by placing conditions on the use of funds, development partners can ensure that their financial support is truly spent on, for example health. Earmarking is thus a financial concept and should not be confused with the purpose of the support. For instance, development partners may support a sector programme and have conditions in respect of reforms and results in the sector without earmarking the support financially to the sector (e.g. through sector budget support).

The effectiveness of **earmarking is highly questionable** and is normally not recommended for the reasons given below.

Earmarking is primarily challenged by the concept of **fungibility**, i.e. that funds are exchangeable. If funds are added to one expenditure area, the same amount of money could be withdrawn and used for other purposes. Consider the following example: The intention of the development partner was to finance 100 new schools. If the partner government's intention was to build zero schools then fungibility would be zero, hence the development partner could claim that the funds were fully used to build the schools. But, if the partner government's intention was to build 50 schools, fungibility would release 50% of the development partner's funds to be used for other purposes. Earmarking the funds for the building of schools was thus highly ineffective. The degree of fungibility is hard to assess, but it is clear that fungibility exists and is dependent upon the degree to which the priorities of the development partner and the partner government coincide. Hence, when development partners support a country's own development agenda and align themselves with the priorities expressed in national policies, fungibility will increase and the effectiveness of earmarking decrease. This is, however, highly desirable from an aid effectiveness point of view and is one of the foundations of the *Paris Declaration*.

Earmarking is also problematic from an allocative efficiency point of view.

Fragmented demands by development partners on funding levels for specific purposes undermine the budget process. Conditions on funding levels limit the possibility to re-allocate resources in line with priorities. Furthermore, it makes the budget process difficult as it does not depart from needs but rather from desired funding levels stipulated in various agreements which are complicated to overview.

Earmarking also adds to transaction costs, as financial reporting is required to prove that development partners' funds were used for the intended budget items.

For these reasons, it is much better to assume a holistic approach and consider all resources available for financing expenditures in the State Budget. This moves the focus from the individual contribution by the development partner to the overall use of all resources in the budget/MTEF. This is a much more effective way of monitoring the use of funds as it recognises fungibility. Development partners need to discuss policy priorities and plans, and check if the budget supports them in its totality. One consequence of this is that budget analysis becomes even more important for development partners.

However, there are different forms of earmarking and, depending on how they are applied, they may have a more or less negative impact. There are also special circumstances under which earmarking may be considered.⁵²

Virtual or Notional Earmarking checks ex-post the use of the external resources made available by a development partner. The partner government receives the financial support and reports back that spending against the specified budget lines has been equal to, or more than, the contribution. This allows the spending to use the national procedures and, as long as the chosen budget lines would have been financed in any case, the resources remain fully fungible and the cost imposed is purely administrative.

Real Earmarking is done ex-ante, i.e. spending on agreed budget lines must precede the release of the external funds. The effect is similar to notional earmarking, but real earmarking requires special bank accounts to hold the external resources before confirmation is given that spending has occurred. This way of earmarking adds to the administrative burden and is likely to impact negatively on cash-flow management.

Regardless of the form of earmarking, reporting requirements may be more or less onerous. In some cases, the individual development partner requires that its financial contribution can be tracked in the system and also requires full expenditure reports including verifications. These extra controls do not in any way ensure that the external funds are used for the intended purposes and the administrative cost is high. If the purpose is to ensure that funds are spent in accordance with regulations and the budget, a better way would be to monitor or audit expenditure reports overall, which could also develop capacity.

Arguments in favour of earmarking include the possibility to visualise the contribution. It may also make it easier to raise funds for a specific sector. The former argument has some merit. Although, due to fungibility, the effect of earmarking is by and large fictional, it may make it easier to defend the support provided for development purposes to domestic constituencies in development partner countries. Politicians could, for instance, argue that increased spending, for example for military purposes, is not financed by development cooperation funds as the support is earmarked for the health programme. The latter argument is more problematic as it undermines the national budget process, as discussed above. However, if it is clear that the budget allocations are distorted in relation to poverty objectives, earmarking may be considered as an option although it would be better to discuss the overall budget allocations, thereby encouraging an overall resource allocation coherent with the poverty reduction objectives. Another case is if there are liquidity problems (treasury tension) which means that budget execution in the sector is in jeopardy due to lack of funds. Real earmarking could then force treasury to give priority to the sector when releasing scarce funds. However, this would often be in

⁵² *Evaluation of General Budget Support: Synthesis Report, IDD and Associates (2006).*

contradiction of the national regulations related to prioritisation of payments. In this case, individual development partners would have an undue influence over national daily budget management, where the sector/area given priority by the donor might receive favourable treatment rather than being treated as part of the larger government picture.

Additionality is another key concept closely related to the above discussion.

Some development partners would like to see that the external resources provided are additional to the (previous) budget(s) of a sector. For instance, if the health budget has been 100, and the agreed sector plan would require a budget of 150, then a development partner which increases its contribution by 50 would not like to see the health budget to be 125. As a consequence, the development partner may either try to earmark the support (which is ineffective as discussed above) or demand a total budget allocation of 150. The problem with the latter is that the overall government budget priorities are not respected. The budget process becomes supply driven by individual development partners who may only be interested in the development of a particular sector. Social sectors may, for instance, be given priority at the cost of productive sectors, despite the existence of a poverty analysis and PRS concluding that resources would be more effectively used for other purposes, or vice versa. The consequences are more severe if the demands are put on sub-items, which could lead to the massive construction of clinics, but no resources for personnel or drugs. **For these reasons, development partners should engage in dialogue on the budget/MTEF and its overall priorities (in relation to PRS and sector plans), but refrain from undermining the national budget process by laying down conditions on additionality.**

Moreover, measuring additionality is virtually impossible as it requires knowing the counterfactual situation, i.e. what would have happened had the additional support not been provided. Other partners might increase or decrease their funding, budget priorities might change for legitimate reasons, the marginal return on additional funds might diminish due to absorption problems, the partner government might increase the domestic contribution less than it intended although it covers the additionality requirement (fungibility), etc.

Appendix 2 The PFM System and its Components

This appendix describes the different components or subsystems of PFM with the aim of explaining major features and characteristics and common issues related to aid and development efforts. As with other parts of the PFM handbook, the appendix does not cover macroeconomic systems and developments or, to any great extent, procurement.

The main PFM functions are depicted in the illustration below:

Planning and Budgeting <ul style="list-style-type: none"> • PRSP • Sector Plans • SWAp • MTEF • Annual Budget • Performance-based Budgeting 	Debt Management <ul style="list-style-type: none"> • Budget Balance • Cash Management • Capital Markets • Debt Policy • HIPIC • Debt Administration 	Revenue Administration <ul style="list-style-type: none"> • Taxes, Excises and Fees • Tax Efforts • Tax Gap 	Accounting and Reporting <ul style="list-style-type: none"> • Financial Information • Computerized Systems • Classification • Annual Statements • Salary and Payroll 	Payments <ul style="list-style-type: none"> • Payment System • Single Treasury Account • Cash Management • Reconciliation • Commitment Control 	Audit <ul style="list-style-type: none"> • External Audit • Internal Audit • Audit Methods • Risk-based Audit 	Procurement <ul style="list-style-type: none"> • Procurement Systems • Diagnose Instruments
Crosscutting issues <ul style="list-style-type: none"> • PFM/HRM, (Professional streams, accreditation, in-service and pre-service training, training institutions, service schemes – salary and advancement structures) • PFM/IT solutions (Systems, support, training, design and responsibilities) • PFM Legislation, (Public finance management laws, bylaws and regulations forms and guidelines) 						

1.1 Planning and Budgeting

Purpose of planning: Preparation of comprehensive multi-annual and annual plans reflecting political priorities and strategies, which allow for monitoring and evaluation of results.

Purpose of budgeting: Efficient allocation of public resources through preparation of a credible, comprehensive and realistic budget reflecting political priorities and enabling democratic control through a transparent and open budget process with public and political participation.

Main activities: Preparation of planning documents including programmes, objectives, activities, costs, sources of funding and related result indicators on a multi-annual and annual basis. Preparation of budget guidelines that determine timetables, actors and budget methods, often the formulation and/or further break-down of sector and organisational ceilings, collection and, at central level, compilation of estimates to be submitted

to the cabinet and parliament, final publication of the multi-year budget and the annual budget/s. Each sector ministry also has a similar process for its institutions and departments.

Common Organization: The MoF, sometimes combined with a separate ministry of planning. Parliament and the parliamentary budget committee are of course also involved. Each sector ministry's budget and/or finance departments. *Offices of the President* and the *Prime Minister* could also be involved.

1.1.1 Subsystems and Functions

National development plans and Poverty Reduction Strategies.

Many, if not most, countries have adopted *National Development Plans*, which sometimes replace, and are sometimes separate from, *Poverty Reduction Strategies*. These plans focus on national development needs and efforts to reach political objectives such as the *Millennium Development Goals* (MDGs) over a period of around five years. Issues relating to cross-cutting reforms such as PFM reform or *Public Sector Reform* (PSR) could be included.

At the same time, the approach of using a *Mid Term Expenditure Framework*, MTEF, is being introduced in most countries. The MTEF is a three-year to five-year budgetary framework giving financial allocations/ceilings to sectors or policy areas. In some cases, the MTEF also discusses the same planning and priority issues that are highlighted in a specific planning instrument. Of course, the MTEF should be aligned with the *National Development Plan* and *Poverty Reduction Strategy*. The difference may be that the NSP/PRSP focuses on development efforts, whereas the MTEF should cover both the development and normal operations of each sector. Ideally, however, there should be a total match and overview between these instruments and the sector plans for each sector.

The MTEF is normally rolling and updated annually, where the first year coincides with the forthcoming budget year. The update process makes the MTEF a much more dynamic instrument than the multi-annual plans, which are fixed. This situation often creates a conflict between the content of the multi-annual plan and the MTEF in different countries. The MTEF should normally be presented by the government to parliament for endorsement. It should contain "hard" budget ceilings for the entire MTEF period for all parts of the budget, including the sectors, which should be approved by parliament annually.

The scope of the financial analysis is widened in a MTEFF (*Mid-Term Fiscal Framework*) which includes the fiscal projections, i.e. both the revenue and expenditure projections for the period, the resulting budget balance and possible deficits, and plans for ways in which the deficit should be covered.

Sector Plans and the Sector-Wide Approach (SWAp)

Multi-annual sector plans are often prepared for the main sectors receiving development support. They also cover a three- to five-year period, development needs and projections, and tentative resource requirements. In the *Sector-Wide Approach* (SWAp) for a sector, development partners and the partner government present a common agreement on the sector plan, how the sector shall be financed, funding modalities and safeguards, monitoring mechanisms, result indicators, institutional arrangements for discussion on the implementation of the plan, etc. When the resource frame for the sector is decided, the sector also needs to develop its own MTEF to ensure that financial resources

available in the medium term correspond to formulated objectives and activities in the sector plan.

The intentions and content of the multi-annual sector plan should be transferred to an *Annual Work Plan (AWP)*, which represents the financial framework for the first year of the multi-annual plan. With the necessary information, the AWP can be used as an instrument for planning, monitoring and follow-up. The AWP should be elaborated to the necessary level of detail, i.e. more detailed information should be added at implementing levels.

Annual Budget

In most partner countries, the annual budget for a specific year is presented with a division into a **capital or development budget and a recurrent or operational budget**. The capital or development budget is meant to contain investments, whereas the recurrent or operational budget should contain the operational costs to maintain government services as well as grants and subsidies, and payments of interest on the state debt. This division is often not that clear as the tendency has been to slot development partner funding through the development budget, thereby giving an overview of external financing. The result is that, at times, substantial development partner-funded operational costs, for example for medicines and school books or maintenance, may be found in the development/capital budget. With the introduction of budget support, this picture may change again. Budget support is reflected and specified on the revenue side of the budget, but in the expenditure budgets it is treated as an integral part of domestically-financed expenditure. Budget support could hence form part of both domestically-financed parts of the capital budget and of the domestically-financed operational budget.

One common problem arising from this division of the budget (and different government institutions responsible for each budget) is that, when new investment projects are introduced in the budget, this is often not accompanied by allocations for necessary and corresponding recurrent costs, for example funds for personnel to run a hospital.

Another important issue is the budget's classification and structure. In most of Sida's partner countries, the budget represents economic, functional, institutional and geographic classifications, as well as programme classifications. In spite of this, the structure of these classifications might not be sufficient to fulfil the needs of different sectors that might have to work through a complementary budget structure.

In Anglophone countries and other countries, the annual budget is often referred to as the **annual budget law**, because it is approved by a parliamentary decision. In addition, there could be an **organic budget law**, which describes the process and rights linked to the budget.

Performance-based budgeting

Performance-based budgeting is currently being introduced in many countries. It represents an attempt to link budget allocations to services and products in the public sector. Performance-based budgeting cannot replace the budgeting of cost items representing the nature of costs and input – such as salaries, travelling, and maintenance. It should rather be seen as a welcome expansion of such budgeting towards the desired end products and as an element of results-based management. Performance-based

budgeting should reveal the results that are expected from the allocations to institutional levels, such as number of schools and pupils trained, clinics and patients treated in certain categories etc. Such information is often included in the AWP as expected indicators and targets to report at year end. Depending on the results, there might be good reasons to change the resource frames provided for different cost items in the next budget.

1.1.2 Common Problems in Developing Countries

Inefficient budget allocations

The allocation of the public resources in the budget is a highly political process. Ideally, it is done in such a way that best benefits development and poverty alleviation. A term used in this context is “**allocative efficiency**” meaning the efficient allocation and reallocation of resources towards the budget’s votes and purposes that best meet the intended political goals – an international example of which being the *Millennium Development Goals*. At the allocative level, the choice stands between different purposes and votes and the aim is to best reflect the situation in the country. In one country, a fairly large allocation may be needed for security purposes, whereas another country may have a larger and emerging need in the education sector. A classic example of allocative inefficiency is where allocations are made in an incremental budget process, which mechanically adds resources to the “old” budget without considering changes in policy, needs and the demands of the population. A situation where large portions of the public sector is financed “off-budget”, i.e. through external grants and loans which are not reflected in the budget, can also contribute to a skewed allocation of resources and allocative inefficiency.

In addition, the term “allocative efficiency” is used to describe the best mix of resources within a certain organisation or programme to reach the goals of the organisation or programme. If one goal for primary education is to promote reading and numeric skills, a certain mix between costs for text books, teachers, teacher training and classroom maintenance may be optimal – giving the best allocative efficiency. Of course, other aspects than the inputs chosen have an important bearing on allocative efficiency – quality of teaching, leadership, etc. Anomalies where teachers’ salaries crowd out other needed resources could, however, be detrimental to the allocative efficiency.

Examples of inefficient allocation patterns can also be found in the balance between resources aimed at the central bureaucracy compared to local service delivery institutions and levels.

Another common source of poor allocative efficiency is due to the split into a capital and an operational budget. When these do not correlate and are prepared independently, the result is often that major capital investments are made without due consideration being given to future recurrent budget implications. A school may be built, but at the end of the process there are no provisions in the operational/recurrent budget for teachers’ salaries or future building maintenance.

Yet another example is the fact that operational resources in many budgets in the countries concerned are only sufficient to cover salaries. This means that there are very scarce resources to perform any activities, since there is no money to buy textbooks, hospital equipment, stationery etc, or to meet any other recurrent expenditures, apart from salaries. This situation makes external financing of a sector – although proportion-

ally small – often very important. These external funds are the only funds available for financing operational activities in many countries.

An integration of the two budget processes (recurrent and investment) and documents is therefore desirable and a sector plan should ideally cover both development and recurrent costs. The documents should also provide details of the allocation pattern of resources for central, regional and local levels.

One common problem in developing countries is that sector ministries are not allowed to influence the budget process and final allocation of resources sufficiently. Since it is the sector ministries that have the best knowledge of conditions in their own working field, this imbalance in the budget formulation process often leads to allocative inefficiencies. The need to enhance sector influence on the budget process has been further underlined through the introduction of SWAPs and comprehensive sector planning on a programme basis supported by development partners. This shift of power towards the sectors represents, in many countries, a huge and fundamental change of roles and positions within the administration.

Transparency and public participation

An effective PFM system secures transparency, democracy and public participation. This is essential at all levels of the system and efforts may be needed to strengthen the role and opportunity of parliament to play an active part in the budget process and the allocation of resources based on political priorities, to enable parliamentary control and follow-up of the audited reports and audit queries, to allow for transparency, competition and right to appeal in the procurement process, and to enable popular insight and participation at institutional and grass-root levels, such as schools and hospitals.

To ensure that such issues are covered, there is a need to engage parliament and other stakeholders in the reform identification process and design exercises. Objectives and indicators relating to targets should also be included and monitored in the reform programme and plan.

Engagement of the public and end-receivers of budget resources in the oversight process could also be important and has been organised in several countries. This is especially vital at the local level to ensure that resources allocated to public services and goods actually reach their intended recipients.

MTEF/PRS/Sector policies and the annual budget

Budget allocations are a crucial element in the efforts to reduce poverty and achieve the *Millennium Development Goals* and other political targets. It is through budget allocations that the scarce public resources are distributed, and can have an impact in supporting the poor and marginalised people in society and pave the way for economic development. In many countries, the PEFA and other assessments indicate that the variance between the annual budget allocated by parliament and the actual outcome is large and that implementation, particularly of the capital budgets and transfer allocations, is poor with large amounts remaining unspent. To make matters worse, there is also often a discrepancy between the long-term allocations suggested by the MTEFs and sector plans and the annual budget itself. The budget is sometimes referred to as a showcase with little bearing on real resource use and actual committed costs.

There can be several reasons for this, examples of which are:

- **Poor commitment control**, meaning commitments in a wide sense – all obligations including salaries, rentals, transfers and ongoing contracts. If these are not brought into the picture, the MTEF and sector plans may become lists of wishes with little bearing on reality.
- **Poor control of the resource envelope available.** Extensive external financing in combination with political instability may lead to a situation in which funds may be withheld or are uncertain. This, in turn, makes it difficult to formulate credible expenditure ceilings and budgets. There may be need to adjust the MTEF methodology to this and to apply scenario budgeting.
- **Underestimated costs and growing, unbudgeted arrears or unpaid bills**, which need to be paid first thing in the forthcoming budget year. One month into the new year there may already be votes that have been exhausted and a need for transfers or reallocations arises.
- **Successful attempts to corrupt the budget process** and delink the resource allocation between the MTEF and the annual budget as well as between the budget and actual resources used.
- **Weak implementation capacity** – especially related to the development budget and programmes, resulting in underutilisation of the budget and a large variance between allocated and utilized resources.
- **Weak PFM systems**, for example the payment system with limited knowledge of actual liquidity in the system and how and when further funds will be available to budget holders.

The first remedy to improve the situation is the provision of accurate and timely records of committed costs and obligations. This can be facilitated by computerising the general ledger and introducing commitment control. Timely and accurate financial reports will then form the basis of a more credible budget for the forthcoming period.

Publication, in the budget document, of the previous year's outcome and a projection of the current year's resource use is also good practice and improves the quality of budget provisions for the forthcoming year.

Early capacity and functional analyses of the actual conditions in the sectors might also persuade development partners to adjust their expectations as to what can realistically be achieved.

The key to discussions on actual execution in relation to expected results is *Results-Based Management*, RBM. Through the discussion of results, issues of informal power structures that interfere with approved budget allocations can be brought up.

An improvement in the use of external funding can be achieved by the scenario budgets, and by maintaining a data bank of prioritised projects that can be implemented as funds become available. Also, an increase in aid provided as general budget support improves the flexibility of governments and the possibilities available to them to make use of funds for prioritised programmes.

1.2 Debt Management

Purpose: To manage government debt at sustainable levels and to minimise the cost of borrowing while ensuring the availability of cash for payments. To enter into and register formal agreements of state guarantees for loans, for example for the investments of government enterprises.

Main activities: Forecasts of long-term and short-term borrowing needs. Management of state debt in both international and domestic capital markets, sometimes the issuing and sale of government bonds and treasury bonds.

Common Organisation: A debt office in the MoF or an independent debt agency. At times a unit in the national bank.

1.2.1 Subsystems and Functions

Budget balance

The macroeconomic analysis of growth in the national economy, and the analysis and forecasts of government revenue and of resource needs should result in projections and scenarios for the budget balance. A projected deficit must somehow be covered and the option of financing through the printing of new bills is not viable if the country is to avoid massive inflation and enjoy the benefits of a convertible currency. External grants from development partners are, for many countries, a first option to finance a budget gap between needs and available resources. In addition, a budget deficit may be covered by loans: the *Bretton Wood Institutions* – the *World Bank* and *International Monetary Fund* – provide credits at favourable rates.

Cash management

A need for credit may be long-term – due to a projected or unforeseen annual budget deficit – or short-term – due to differences in revenue and expenditure cash flows over the year. In both instances, there is need for a debt management system in government that can keep track of the credits needed in a short-term and long-term perspective and that can manage and administer the debt portfolio to ensure that the provision of cash is secured at a minimal cost.

Capital markets

Governments can access and take loans on the international and domestic capital markets. The interest rates asked for the loans depend on international market conditions and the rating made of the country's creditworthiness or the risks involved. The sale of bonds/treasury bills on the domestic capital market is not always an option as the capital market and prospective buyers may be virtually non-existent or the credibility of the government too low.

Debt Policy

The development of a debt policy is desirable for every government. Some of the elements of such a policy would be ceilings for debt levels, the desired mix between long-term and short-term credits, a policy for international and domestic financial institutions and markets, responsibilities and decision-making arrangements, and a development policy.

HIPC

The HIPC initiative was launched by the *World Bank* and the IMF in 1996. It aims to alleviate – write off – the debt burden of the “Heavily Indebted Poor Countries”. To qualify for debt relief, certain criteria must be fulfilled which relate to the poverty level, debt burden, the budget allocations and balance, state of the PFM systems, and the development efforts made. The resources freed by debt relief are intended for use in poverty reduction programmes funded through the national budget. 41 countries were identified as possible candidates for HIPC. To be eligible for HIPC, one requirement is that the country must have a poverty reduction strategy (PRS).

Debt administration

The prudent administration of the government loan portfolio involves registration of loans and loan-related transactions, projection of interest and repayments, timely payment of the same, and timely acquisition of new loans when required. A few recognised computerised systems to manage state debt exist. For example, the IMF supports the introduction, adaptation and installation of such systems.

1.2.2 Common Problems in Developing Countries

Large public debt

A succession of years of public budget deficits may result in a considerable debt where payment of interest alone consumes a large portion of the national budget. Levels where the total debt surpasses the amount of annual GDP are not uncommon, which may result in drastic programmes to cut public expenditure, increase revenue and reduce the debt burden. As always, the public debt and budget deficit trends are of importance in the debt analysis.

Lack of overview and preparation

Poor forecasting of both revenue and expenditures and of income and payment flows may result in unpredictable loan needs that are covered by short-term and expensive loans.

General improvements in other PFM systems, such as budgeting and financial reporting and accounting, will make it possible to improve the quality of debt management.

In addition, orderly registration and reporting on the loan portfolio and related payments is one key to efficient debt management. The application of a computerised debt management system assists in this respect. Other types of capacity strengthening are also recommended, for example knowledge of debt management, control of loan instruments, matching of borrowing and transfer of funds to liquidity prognoses, etc.

Analysis of the debt portfolio and development of a debt policy

Many countries have experienced a situation where knowledge of the debt is kept secret, is scattered, or is not available. Of course, it is essential for purposes of analyses and financial planning that the public debt is known and that statistics related to the debt are public and transparent. IMF and the PER analyses contain, in most cases, information on the public debt.

It is often possible to reduce debt costs through an improved debt portfolio and loan mix based on an analysis of existing options on the international and domestic markets. The analysis should also provide an input for a debt policy that can guide future loan decisions.

Poor domestic capital market

The domestic capital market may be undeveloped. There may well be a need to develop instruments and institutions – to issue state bonds, advertise such opportunities and administer sales of bonds, pay interest and make repayments. However, domestic borrowing can come at a high cost to the economy if credit to the private sector is crowded out.

1.3 Revenue Collection and Administration

Purpose: To mobilise sufficient external and domestic public resources in line with political priorities, to ensure equitable, fair, transparent and efficient revenue collection and administration.

Main activities: Projections and regulations related to taxes, customs and other revenue items such as fees. Maintain tax registers and administer tax bills and receipts. Follow up of tax arrears. Customs control at ports of entry, collection of customs due.

Common Organisation: A revenue authority, sometimes split into one for taxes and one for customs. Sometimes, the tax organisation is a department of the MoF. Fees are often collected directly by service institutions such as hospitals and schools or by municipalities and public enterprises. In some countries, the revenue authority has local offices.

1.3.1 Subsystems and Functions

Taxes, excise and fees

Taxes are the contributions to the public sector stipulated by legislation and regulations which are not directly related to service consumption. Pensioners or corporations may, for example, be required to pay tax that is used for primary education although they do not directly use that service themselves. A distinction can be made into direct and indirect taxes. Examples of direct taxes, which are paid directly by the taxed entity to the public sector, are income tax, property tax and land tax (rates). Examples of indirect taxes, i.e. taxes paid indirectly, are VAT – value added tax and excise (e.g. tax on luxury goods or petrol).

Fees are contributions collected that do relate to the consumption of a specific service. Examples are school fees and hospital charges. For the institution concerned, these could represent a substantial part of total resources and may be subject to corrupt activities.

The tax mix, i.e. the mix between different taxes in a country, is of interest for analysis as it has effects on poverty reduction and other targets and also determines whether there is scope for increasing revenue collection.

Fees and taxes collected at the local level (in municipalities or by local government authorities) often represent only a small part of resources available. Most of the income of the local administration is normally direct allocations in the state budget or transfer

of (block) grants from the central level. This implies, at the same time, a strong financial dependency on central government.

Revenue administration

The efficient organisation and administration of taxation and revenue collection is an important part of the PFM system. Good practices include a competent revenue organisation, specific service to - and emphasis on - large taxpayers, minimal personal contact between revenue authorities/collectors and the payee to reduce the risk of corruption, and the introduction of *Pay As You Earn* (PAYE) systems where employers deduct and pay the income taxes of their employees.

Tax effort

It is not possible to determine a fixed level which can be regarded as a “reasonable” tax contribution as a percentage of GDP. This depends on a number of political and cultural aspects such as the role given to government as compared to the private sector or family sphere, for example for health and child care and care of the elderly. One may, however, be able to determine a minimum level below which it would be difficult to maintain even minimal government services such as security, leadership, basic infrastructure and defence, and where there is little room for any public efforts to reach social targets and marginalised parts of the population. The few countries that fall below a level where public tax collection is less than 10% of GDP are likely to face problems in these regards. There could also be a maximum level where taxation may provide disincentives to productivity, raise prices of commodities, and hamper a country’s possibilities to compete on global markets. Assessments of the tax effort need to be made carefully, taking situational and cultural aspects into consideration, and will also depend on the overall poverty level in the country. Taxation and grants are among the most important tools for governments in the redistribution of income to the poor.

Revenue items and Appropriations in Aid

In the annual budget, estimates of tax collection are reflected as categories of tax in the specific revenue budget that finances the expenditure budget. Most taxes are not earmarked for specific purposes or expenditure areas. Budget support should basically be treated in the same way as well as profits from public enterprises. If expenditure estimates exceed revenue estimates, the resulting estimated deficit should be revealed in the budget as well as in the form of a proposal to parliament for the financing of the deficit.

Estimated revenues, mostly fees for specific services that are collected or registered with a specific government agency, can appear under the different expenditure votes as *Appropriations In Aid – AIA*, meaning that they are used to finance that vote and that they also have reduced the appropriation needed from the central revenue budget. Technically, they offset part of the estimated expenditure. If the actual revenue collected exceeds the estimated AIA, the excess has to be surrendered to the treasury.

1.3.2 Common Problems in Developing Countries

Large tax gap and poor compliance

Revenue administration and collection is a common problem in many partner countries. The tax legislation and regulations may be complicated and not well known. It is an area where corruption is widespread. One measure that reflects the discrepancy between taxes due and actual tax collection is the tax gap. Poor tax compliance will, of course, affect a government's prospects of implementing its programmes and services. Analysis of the tax gap and efforts to improve compliance and collection are often important aspects of a PFM reform plan.

Shortcomings in revenue forecasting will also lead to situations of liquidity shortages and problems linked to this. A contributory factor to the difficulties in revenue projection is external financiers to the state budget; i.e. development partners. In most countries, there is a substantial discrepancy between development partner pledges and actual disbursements (in time for the fiscal year when the funds are expected to be received), especially in the medium term. This is an institutional problem and should not be accepted by partner governments.

Generous exemption policies

Some countries exercise generous policies of tax exemption for foreign investors or even certain companies for more or less transparent reasons. The effect is seldom of benefit to the country in question as there is a tendency for countries to overbid one another in tax exemptions to attract investors. At times, the investors choose to de-invest and move to a new country once the exemption period has elapsed.

Imposed tax policies

The tax mix in many countries is a result of external factors that exert a strong influence on the process, for example trade liberalisation and the dismantling of tariffs. A focus on indirect taxes may be regressive, i.e. put most financial pressure on the poorest in the population. There may, therefore, be a need to exempt certain categories of goods.

1.4 Accounting and Reporting

Purpose: To ensure budget control and releases in line with the approved budget, provide accurate and timely financial information, financial control and good governance, and facilitate audit.

Main Activities: Determination of accounting regulations, methods, systems, structures and codes, control of accuracy and compliance with regulations, budget monitoring, registration of financial transactions, forecasts of annual outcomes, presentation of annual final accounts.

Common Organisation: Treasury within the MoF (or a separate accounting department), sometimes in combination with a comptroller function to oversee the system. The accountant general or director of accounting is responsible for the accounting procedures and systems. At times the functions are combined.

1.4.1 Subsystems and Functions

Financial Information

Accounting is the processing and registration of financial data related to specific economic events or transactions over a year. Registration has been manual – and still is in many countries, especially at institutional, local and regional levels. The computerisation of financial information systems is, however, a strong development effort in most countries, leading to improved access to and timeliness of data and reports, and better control. Computerisation also creates opportunities for multidimensional reporting of financial data.

The financial information needs determine the data structure and registration required. These needs differ over the year and also between the various stakeholders. On an annual basis, the annual statements of revenue and expenditure are required with a presentation of the total outcome for different votes and items as compared to the budget. An annual statement of assets and liabilities – a balance sheet – is also required to keep track of changes in these regards – at the national level of the public debt, of assets acquired and sold or depreciated, and of liabilities related to, for example, pensioners, employees, suppliers and other entities. Monthly statements of revenue and expenditure allow budget holders and the MoF to keep track of overspending and poor implementation. Registration of commitments adds value as it adds costs that have been committed but not yet paid.

For the auditor's examination of compliance with accounting regulations and standards and also for the controls exercised by budget holders and accountants, it is important that the figures in the monthly, annual and other reports relate to, and can be traced to, individual specifications of transactions. The supporting documentation for these must be available and possible to retrieve. In cash books and general ledgers (whether computerised or not) transactions are registered with a numbered reference to payment vouchers. These are to be kept in order and safe custody and contain relevant signatures of budget holders authorising the payment, invoices etc.

Registration is guided by a chart of accounts and codes. Computerised systems allow a multiple coding structure where a single transaction, such as the payment of an invoice, can be given specific administrative, economic, functional and/or programmatic codes, allowing the system to present financial information in all these dimensions. Codes assigned to administrative units refer to the organisational structure and often budget holders; economic codes or classifiers reflect the nature of revenue and costs such as salaries and maintenance; functional codes refer to main purpose or sector; and programmatic classification to sub-programmes or other divisions. In addition, there may be a need to assign codes and code fields to report according to a geographic or regional pattern and on sources of finance. Of course, there is also a certain information structure in traditional manual and single entry bookkeeping. Here, information requirements are often met – but to a more limited degree – through hierarchical structures where code structures and books of accounts represent a structure, starting with a division into the votes and sub-votes of the budget which represents sectors/ministries and sub-sectors. Under each vote and sub-vote a division into group items and detailed items exists, by and large corresponding to nature of cost.

There are international standards for some of the information structures. The GFS – *Government Financial Statistics* standard issued by the IMF – stipulates the information

structure in the annual reports of government revenue, expenditure and balance sheet. They determine the basic structure for the economic nature of costs, revenues, assets and liabilities. The UN have issued the COFOG standard (*Classification of Functions of Government*) for financial statistics related to sectors and purposes of spending such as primary education, security etc. (The degree of application of these standards is examined and included in the PEFA assessment benchmarks.) In addition, IFAC – PSC (*International Federation of Accountants’ Public Sector Committee*) has issued a number of IPSAS – *International Public Sector Accounting Standards*. The IMF also produces international standards in a series of the *Reporting Framework for Observance of Standards and Codes* (ROSC), of which some concern PFM.

Principles and models – cash or accrual accounting

The records of financial transactions shall ideally provide a good picture of resources used over certain period, as well as of the relative wealth of the organisation, through records of assets and liabilities at a certain point in time, especially at year-end. These records are linked so that the net value of annual revenues and expenditure, as reflected over a year, would tally with the corresponding change in overall assets and liabilities, and the residual between the two – the consolidated fund.

For private firms and the commercial sector, the above is fully reflected in the annual accounts. For the reporting to be accurate, it is then necessary to use so-called accrual accounting, meaning that expenditure and revenue are referred or accrued to the actual period of time when resources were earned or when resources were consumed. Such accrued accounts would reflect the use of assets as a cost only insofar as the value of the assets was reduced for a particular year. A vehicle with a life span of five years would be registered as an asset in the balance sheet first at its full value, and then be depreciated over a period of five years. Each year a fifth of the value would be registered as depreciation of the asset and as a cost for the year.

Governments normally apply a system of accounting on a cash basis, meaning that the full payment or receipt is registered when it occurs in the revenue and expenditure accounts. The full cost of the vehicle hence appears as a cost at the moment of its purchase. This simplifies accounting (and at the same time make it less complete as, for example, it is more difficult to establish a balance sheet) and there should be full correspondence between the change in the cash balance and the summary of revenue and expenditure for a period.

There is also the possibility of applying modified accrual accounting, meaning that revenue and expenditure of a certain nature are accrued in order to improve the accuracy of the annual statements of revenue and expenditure and facilitate the production of a limited balance sheet.

Today, few countries apply full accrual accounting in government accounting (Sweden, New Zealand and a few others). The advantages can be said to be that it:

- provides a more accurate presentation of public finances in terms of annual resource use and receipts earned, and of assets and liabilities.
- facilitates the integration and consolidation of different aspects of the PFM system, such as commitment control, debt management, registration of pension debt, advances to staff, cash management etc.

Disadvantages are that:

- accrual accounting is designed for the private sector. The registration for the public sector of the budget and of the use of grants or appropriations is rather complicated and calls for specific rules and reports.
- accrual accounting is more complex to register and to correct. It places higher demands on accounting staff and budget managers.

The recommendation for most partner countries would therefore be to abstain from accrual accounting in the initial phases of computerisation. Also, the introduction of modified accrual accounting at a later stage could be a better solution than to aim at full accrual accounting from the outset.

There are many other considerations to be made that refer to the accounting model for a government's financial management and accounting system. There is need to determine whether the state is to be treated as one entity with a uniform chart of accounts and codes, or if each ministry and agency should register financial transactions and prepare their reports individually and mainly in accordance with a combination of central reporting requirements and their own needs. There is need to define how transactions between government entities, and transfers to other entities, should be treated and whether appropriations paid initially should be treated as revenue or advances.

IT support

The introduction of computerised systems necessitates IT literacy and access to IT support. There will be a need for appropriate skills and support to provide service for installation and technical support, to secure that back-ups are made and data restored in cases of distortion, to install up-dated versions, introduce new users, provide protection against intrusion as well as a functional operational environment for servers and a communications infrastructure.

Such services can be supplied by private service providers or through in-house service organisations. It is important to ascertain that capacity for IT support will be in place when the computerisation of major PFM processes is considered, and to make this part of the reform plan.

Tracking surveys – PETS

Specific surveys are often undertaken in connection with sector planning and reviews to examine whether the intended and budgeted resources reach the service delivery level and end users. These are called *Public Expenditure Tracking Surveys* – PETS. These surveys investigate the actual outcome as compared to budget at institutional level, whether salaries are paid in the full amount and to all employed, if there are “ghost workers” receiving salaries, whether there are sufficient funds for other needed cost items such as school books and maintenance, and whether capital projects are being implemented. *Public Expenditure Reviews* examining PFM conditions in the sector could also include this kind of information.

Integration of processes and systems

Computerisation opens up possibilities for greater integration and improvements in the control and accuracy of data. Registration of orders placed, invoices received etc can be made at an early stage and make it possible to trace both existing commitments and payments made to suppliers. With systems that include payment orders to banks, the opportunities for easy reconciliation are enhanced. They will be further enhanced if the bank and accounting systems use the same cheque or reference numbers and records can be reconciled automatically.

In connection with computerisation, it will be necessary in most cases to have a thorough process mapping and re-engineering exercise. Routines and processes may be greatly simplified and result in substantial savings in time and staff.

Salary and payroll systems and controls

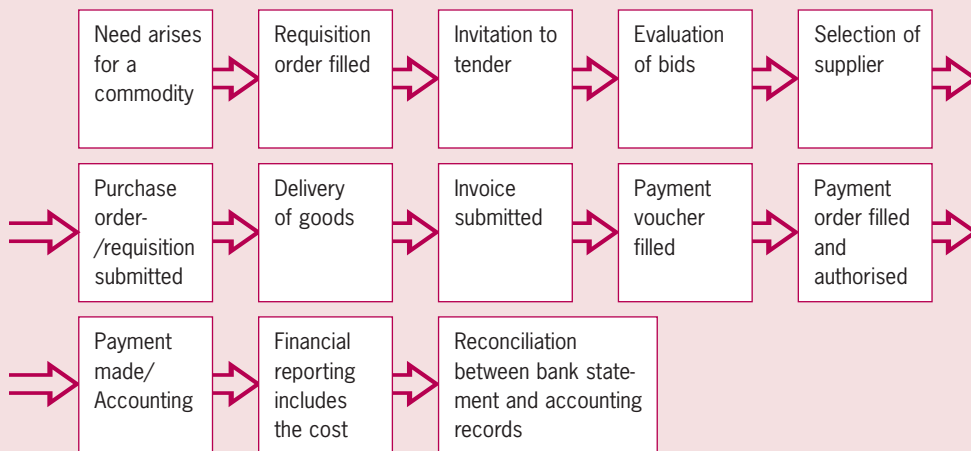
A particularly important area for integration is between payroll and accounting systems. Payments of salaries and wages are made monthly or at regular intervals and need to be recorded in the accounts just as any other expenditure. Sometimes, payroll and accounting systems are developed in isolation and not properly integrated, resulting in tedious manual reporting of salaries into the accounts and of reconciliation problems related to advances to employees, newly employed staff, retirements etc. There can also be substantial numbers of so called “ghost workers” who are not entitled to the salaries paid to them. With split systems it may be difficult to hold managers accountable for salary payments and to exercise the necessary control.

Efforts should be made to integrate the payroll system with the accounting system. Also, systems for human resource management and records benefit from a relatively high degree of integration with the payroll component or system.

Commitment Control

A common problem for budget-holders when they want to check whether their expenditure is in line with the budgetary provision is that accounts only reveal expenditure at a late stage, after the payment has occurred. One method to overcome this problem is through the use of a commitment control system – a system which is often integrated with the computerised financial management system. Planned expenditure is then registered before the payment is made, at the stage when the decision is taken to acquire a good or service. The committed amounts are added to payments that have already been made in budget monitoring reports, thus giving an accurate picture of the remaining budget.

The following illustrates the route, sometimes very long, from identified need to financial reporting, and the many steps involved.



In instances where a commitment control system is in place, the cost of the commodity may be entered at the stage when the requisition is made. Payments are often a critical instance as it is necessary that funds are available. There are examples where as many as 20 signatures are needed before an invoice can be paid. Sometimes, the check on the availability of cash takes place in the phase when the requisition has been placed, in other instances it may take place only after the invoice has arrived and shall be paid. Liquidity problems and the late disbursement of funds is often a problem in developing countries. Clear commitments and timely disbursement of funds from development partners is one key element in securing a predictable cash flow.

1.4.2 Common Problems in Developing Countries

Computerisation and IFMIS

There is a multitude of problems related to the introduction of advanced financial information and accounting systems in partner countries. The so-called IFMIS systems – the integrated financial management systems – normally contain a number of integrated functions that can be taken into use. Some main functions can be:

- General ledger
- Purchase Order
- Accounts payable
- Cash management
- Budgeting
- Financial analysis
- Accounts receivable
- Payroll
- Pensions
- Fixed asset management
- Inventory
- Property management
- Fleet management
- E-procurement
- Debt management

Other PFM systems are seldom fully integrated into the IFMIS; in particular tax registration and administration systems are kept separate as well as customs registers and pure personnel data systems, although a degree of integration with the payroll for the latter is an advantage.

As there have been many attempts to embark on computerised PFM systems, there are a number of lessons to be learned. Some of the attempts have been successful, others not. A *World Bank* conference held in 2004 produced some of the following conclusions:

- the cost is normally high and ends up above the original estimate.
- it takes around 10 years for a full system to be up and running.
- the success rate is only around 40% – many systems have failed.
- there are reliable package systems on the market; bespoke systems can work but create vulnerability and are, at least initially, more expensive.
- there is a tendency to start with a full-scale IFMIS, while only using a limited part of its capacity – like a jumbo jet with few passengers.
- one useful approach has been to start with a limited number of modules – for example, the general ledger and commitment control – and then expand later.
- another useful approach is to pilot the system in a ministry in order to learn before full roll-out.
- the training cost is perhaps the largest cost component and is often underestimated.
- it is essential to create the support environment.
- it is essential to go through processes and decide on the accounting model at an early stage, and to go through and adjust charts of accounts and codes.
- all systems need a substantial amount of adaptation to the local set-up and needs.

The establishment of an IFMIS system raises new questions as to roles and responsibilities in the PFM system. The IFMIS solution can have different forms and architecture. Is it a distributed system where line ministries have their own databases and servers, regularly reporting some key data to the MoF, or is it a central system run by the MoF with workstations in line ministries?

Whatever the solution, the partner country needs to be strengthened in its needs analysis and technical specification work and in the assessment of, and dialogue with, suppliers. There is also a need to include line ministries and spending agents in the planning at an early stage to enable them to voice their specific demands – be it towards the private suppliers and computer companies or the MoF. There should always be room in the IFMIS system to cater for the individual, local needs of line ministries. This may not be automatically realised by a MoF which is fully preoccupied servicing the cabinet, parliament, development partners and auditors.

There is need for Sida to ensure that the inclusion of computerisation in the PFM reform plan does not become overambitious and unrealistic. There is also need to ascertain that sufficient capacity building efforts are included in the plan and that line ministry and other levels of government also get their information needs covered.

Suspense accounts

Suspense accounts are used to register a transaction which needs further coding and a final posting to the correct vote and account – a sort of temporary posting while the matter is under investigation. Any organisation may receive invoices where the information is incomplete as regards responsible department, references to orders etc.

Also, payments of salaries may have occurred where it is not possible to identify the department or institution the person belongs to. Erroneous codes and entries may also temporarily end up on a suspense account. These accounts should, however, be cleared regularly and all matters referred to them investigated without delay. Situations where large amounts and a large number of transactions are referred to suspense accounts, and

when the accounts are not cleared by the year-end, are a signal of poor procedures and weak financial management. Normally, this would be detected by audit and result in audit queries.

Reconciliation

Reconciliation of accounts with bank statements is a fundamental process to ensure control of public finances. Payments and receipts are normally reflected in the accounts, both in relation to how they affect the bank or cash account and related to an expenditure account (vote/sub-vote/item). This can be done through a one-dimensional cash entry system or through double-entry book-keeping. In any event, the resulting cash balance should correspond to the status of the bank account – plus or minus certain known deviations depending on outstanding cheques that have not yet been collected, errors etc. To check that the books of account tally with the bank statements and to trace the reasons for any discrepancy, it is necessary to conduct a regular bank reconciliation exercise. Whenever required, the accounting officer should be ready to explain in detail the nature and reason for any deviations. In cases where bank reconciliations reveal large unexplained differences, there is reason to doubt the quality of the accounting records. It may even be a signal that unauthorised payments are being made which are not at all reflected in the books of accounts. The engagement of external audit may be necessary to remedy the situation – in combination with improved routines and controls.

Poor timeliness

Manual procedures and collection of financial data from local institutions and regions may be time-consuming and the reporting of outcomes delayed. This is a common problem and delays of up to six months before a monthly statement can accurately be produced are not uncommon. This is particularly problematic when there is need to establish budget balances and to determine the need for resources or to prepare a budget. Routine improvements and simple computerisation of general ledgers are means to speed up the process.

Poor quality

Some organisations suffer from a lack of appropriate skills and quality in their financial reporting. This can be due to poor coding and classification, a typical example being where votes are exhausted one at a time regardless of the purpose of the expenditure incurred. In such cases, the information in the financial reports provided is of little value and analysis becomes cumbersome. Spot-checks and the audit should reveal such anomalies and provide recommendations to remedy the situation.

The integration of payroll data

Poor integration and a mismatch of payroll data and the data in bank statements and accounts are common problems. This is serious since the payroll represents such a large part of the recurrent budget. It is important that the IFMIS systems are designed in such a way that allow a large degree of integration and that code structures and charts of accounts in the systems are one and the same.

Proper accounts in relation to budget reports

Inevitably, there must be correspondence between the budget structure and the accounting structure to enable monitoring of budget execution. The accounting structure should, however, not be limited to the budget structure only – especially if modern accounting systems have the potential to deliver financial reports in accordance with a number of other important information needs and structures.

1.5 Payments

Purpose: To ensure the timely and correct payment of a government's financial obligations. To secure cash management that optimises the availability of funds when required at a minimal cost through the harmonisation of income and expenditure flows over time.

Activities: Management of information related to payments and accounts. In some countries, the actual distribution of cash for payment forms part of the government's undertakings.

Common organisation: Treasury within the MoF, exchequer function for control of payments. Payments can be made through the banking system or through manual distribution by treasury and regional/local offices to MoF/treasury.

1.5.1 Subsystems and Functions

Payment system – Payments of state budget expenditure

From the bank account for state budget expenditure, funds are disbursed centrally to the government ministries for expenditures specified in the national budget. Funds must also be disbursed to provinces, regions and districts, primarily for expenditure on various welfare services included in the national budget. Sometimes, payments are made to the lower levels of government via government ministries; sometimes they are paid directly from the MoF to the corresponding financial administration at the provincial, regional, or district level. Disbursements are made in a variety of ways, but in one model the particular agencies receive a portion in advance, after which they can request reimbursements of expenditure. Some countries have introduced a strict cash disbursement system (cash budget) in which funds are disbursed only as and when a corresponding amount is physically on deposit in the bank account for national budget operating expenditure. The cash budget system is extremely effective as a cash management instrument as payments cannot be made until sufficient revenues have been collected or other funds have been made available – but, at the same time, could have a severe restrictive impact on implementation and development.

Most countries differentiate between disbursements for salaries and for other costs. Salaries are often paid centrally (directly via the MoF or the particular ministry concerned), while funds for other expenditure are transferred to lower administrative levels for disbursement there. Consequently, welfare services are often paid both centrally (a large part of welfare expenditure finances teachers' salaries, for example) and locally. There are special payment routines for investment funds, depending on how much money is needed in a particular period.

Institutions often have access to petty cash accounts, which permits cash payments of small amounts. The petty cash receives an advance which is registered in the accounting

system. Payments to and from the petty cash are registered in a separate petty cash book. Registration of petty cash payments are also transferred at an aggregate or specific level to the accounting system at regular intervals in connection with clearance of the advances.

STA – Single Treasury Accounts

Advances paid to lower level bank accounts, collected revenue, and external grants held in separate local bank accounts often add up to substantial liquidity. At the same time, other accounts may suffer deficits that need to be covered by loans, or payments may be delayed due to cash shortages. Treasuries have therefore introduced so-called single treasury accounts, in Latin countries *conta unica* (or *Cuenta Unica*), linking all government bank accounts to one account where, on a daily basis, the net aggregate standing of all the government's bank accounts is reflected. In this way, cash can be more readily available as it is not locked on separate accounts, and the cost of borrowing can be reduced. The solution needs to be negotiated with the banks and is, in most cases, a “virtual” arrangement as actual payments do not take place between the different accounts.

Cash management – liquidity

As was shown in the section on debt management in this appendix, the short-term and long-term balances of the budget cash flows need to be projected and any deficit – whether long-term or short-term – covered through the debt administration. There are specific methods and systems that can be used to predict cash flow and improve cash management. Also, the effective management of payments and revenue collection and a system with a single treasury account can reduce borrowing needs.

From this it also follows that sectors need to make cash flow plans to inform the treasury of their needs. This is important as the expenditure profile often varies substantially over the year. For instance, it may be necessary to make procurements of medicines at the very start of the year. Well-developed cash flow plans are also essential for commitment control. Normally, commitments would be granted up to the level of the amount in the cash flow plan. Without well developed cash flow plans, the sector risks spending the budget at the same pace over the year, although the seasonality of expenditures may be towards the end of the year. In such a situation, the budget will be exhausted by previous commitments, which the control system has not captured as it has been based on weak cash flow plans. Effective cash planning is thus crucial for effective budget execution and predictable financing to sectors.

Responsibilities

Many countries have a system of centralised approval of payments by the treasury in the MoF – at times in combination with regional treasury offices. The approval of the treasury may be required before an order or requisition can be made. In other instances, approval is given when the invoice has arrived and goods have been delivered. Where the PFM capacity is at hand in line ministries, delegated responsibility for payments and a predictable release of cash to the line ministry and regional levels should be in place.

Development partner payments and cash flows

In simple terms, the most common model for the transfer of foreign aid is for the money (all or part, called tranches) to be deposited ultimately in a “forex” bank account, usually in the partner country’s central bank. This is a bank account denominated in a foreign currency, often US dollars.

The treasury in the ministry of finance operates the governments’ bank accounts at the central bank. When programme support funds are transferred to the treasury’s bank account(s) from their forex accounts, they move from the development partner(s) to the government in the partner country. The usual intended route is for the funds to be transferred to the bank account used for financing expenditure in the state budget. (This is sometimes called the treasury account but has many other names, such as the static revenue fund account or the consolidated fund account.)

Important questions in this context are:

- Is there any registration via account statements or through separate accounting routines (from the MoF or the central bank) showing the transfer of money from the forex account to the intended bank account for payment of state budget operating expenditure? Is there any particular agreement between development partners and the government (MoF) for this type of separate accounting routine? Certain countries may have individual agreements between a development partner and the government on the accounts that are supposed to be reported. In other countries, a group of development partners may agree to follow a common and coordinated routine. Regardless of the system used, it is vital that the transfer of funds from the forex bank account to the account for financing expenditure in the state budget (and no other bank account) be accounted for and that the funds deposited in the account denominated in the country’s own currency, correspond to the value of the foreign currency that was transferred from the forex account, based on the official exchange rate. If this type of accounting is not already in use, it should be introduced as soon as possible. The central bank’s overall reporting of transactions between all the bank accounts at the central bank (which includes accounts held by the treasury function at the MoF) is often inadequate as an instrument for ensuring that programme support funds reach the bank account that finances operating expenditure in the national budget. Funds for programme support often require the additional, independent accounting routine mentioned above.
- Are fund transfers for programme support audited periodically? Is there an agreement that the transfer from the forex account to the bank account financing the national budget should be audited, and do development partners have access to these audit reports? What sanctions apply if these audits show that the funds transferred to the bank account for the national budget do not correspond to the funds withdrawn from the forex account? This type of audit can be included in an audit of all the central bank’s cash flows but usually also needs to be performed separately, by special agreement, for the transfer of programme support funds alone.

Examining the transfer between the forex account and the account for financing expenditure in the national budget is not in itself sufficient to ensure that all funds for programme support have ended up in the latter. One must also, for a variety of reasons,

including fungibility, be aware of other bank accounts held at the central bank, or in other banks, by the treasury function at the MoF and how these accounts are linked, i.e. which transfers can be made and are actually made between these accounts. This raises the following questions:

- Is there awareness (and knowledge²) of the structure of bank accounts in the government's payments system that are held by the treasury function at the MoF? Do you know which of these accounts are linked and how funds can be transferred between them? Are regular, separate and independent audits performed on the bank accounts held by the treasury at the central bank (and other banks)? Are the audit reports public or available to development partners?
- Is the bank account for national budget operating expenditure audited under a separate routine? If not, how can one compare the funds used to cover operating expenditure in the national budget with the balance on that account? In other words, how does one know that funds have not been withdrawn from this bank account for purposes other than paying budgeted expenditure? Note that this bank account receives funds from various sources: national taxes, customs and other revenues, loans from various lenders, and donations.

Reconciliation

As described under the section on Accounting in this appendix, the bank reconciliation is important to secure that all transactions are accurately captured in the accounting system and reports.

Trust Funds

A recent trend in countries with PFM systems where assessments indicate a high fiduciary risk level is to channel payments through a so-called trust fund where several development partners can pool funding into a joint fund. Funds are released from the fund by the lead development partner into a forex account at the partner country's disposal. The releases are made in the form of reimbursement of expenditure that has met certain criteria such as compliance with procurement regulations and government or other financial regulations, and are within approved budget and staff ceilings. The compliance is checked by an independent monitoring agent or the lead development partner. The problem with this kind of arrangement is that, in practice, it is disregarded by fungibility. A corresponding amount to that released could be used at any time for other purposes in spite of the high fiduciary risk as long as one part of the expenditure programme is financed outside the trust fund.

1.5.2 Common Problems in Developing Countries

Centralised payment systems

To secure the availability of cash, many governments operate an extremely centralised system for the approval of payments in which the central treasury has to authorise all payments. This creates extreme delays and bureaucracy. In situations of cash shortage or excessive controls, payments may be delayed, and the credibility of government amongst suppliers suffers to the extent that deliveries come to a halt. Also, budget holders and institutions cannot receive necessary materials and inputs on time. The system

may lead to underutilisation of the budget and to poor service delivery. In instances of cash shortages, salaries often get the highest priority, although at times even salary payments are severely delayed. Delegation of payments is an important PFM reform aspect to improve service delivery, but needs to be linked to systems and capacity building that can ensure that aggregate fiscal discipline is preserved.

Late disbursement of funds

Centralisation in itself often leads to delays in payments. However, development partners may also contribute to these delays if external grants are paid late in the year or are subject to cumbersome and bureaucratic processes and conditions. This is a very relevant issue in relation to payment of general or sector budget support. It is important that development partners agree to disbursement mechanisms and timetables so that payments are transparent and predictable. Payments can be made in agreed tranches or portions over the year, sometimes subject to certain conditions.

Unreliable cash flows and payments

When payments to suppliers and employees have to await an unpredictable inflow of revenue, this has detrimental effects on the credibility of government and the morale and commitment of employees. At worst, the budget loses its meaning and actual payments become a daily competition for the scarce available resources. The invoices with the best political backing get paid and salaries may be released only after strikes and violence, with priority given to the police and military services. At the same time, a pile of arrears and unpaid bills builds up. The situation is, of course, aggravated if the revenue budget is overestimated and the budget for expenditure is underestimated, especially for already committed or so-called non-discretionary costs. Improved budget realism and cash management, control of non-discretionary costs, arrears and commitments, and a complete picture of the number and location of all bank accounts in the government's payment system are the key to improve the situation.

1.6 Audit

Purpose: To provide timely independent information on effectiveness and efficiency in government operations, compliance with financial rules and regulations, and quality of financial reports and information, ideally based on an assessment of risks involved.

Main activities: In-year and end of year control and assessment of compliance with financial regulations and of the accuracy and quality of financial information and internal control systems. Performance audit assesses the efficiency and effectiveness of government service provision.

Organisation: External and internal audit organisational arrangements differ between countries.

1.6.1 Subsystems and Functions

Internal audit

Countries have different systems with internal auditors in agencies, individual ministries or as a function in the MoF (with seconded or designated auditors covering all parts of government). Internal audit forms an integral part of the institution audited, reports

internally within it, and is accountable to management. The purpose is to help an organisation to develop appropriate internal control systems and accomplish its objectives efficiently. Internal control is, however, the responsibility of management and is supported by the scrutiny performed by the internal audit function. Examples of internal control systems are the implementation of the principle of duality⁵³, commitment control, competitive bidding for goods, etc. Internal control can broadly be defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations.

External audit

The essential function of external government auditing is to uphold and promote public accountability. The audit is based on the country's legislation, sometimes the constitution, and the auditors are based outside the organisations authorised to spend public funds. The audit is carried out by an independent institution usually reporting to parliament. Often audit reports are handled by a special committee in parliament – often the *Public Accounts Committee* (PAC) in countries with an Anglo-Saxon tradition. The internationally recognised national audit institutions are members of INTOSAI (*International Organisation of Supreme Audit Institutions*). Some of these institutions are organised under as an independent agency led by an auditor general, while others are organised as a court with the right to prosecute and sentence. The court arrangement follows the Latin tradition. Countries may also have other audit organisations, as the *Audit Commission* in the U.K., which is responsible for audit of local government, and the *Dutch Algemene Rekenkamer*.

INTOSAI's Code of Ethics and Auditing Standards provide a framework and guidance for external government auditing. Based on these standards, each institution develops audit manuals and guidelines. The full scope of government auditing includes regularity audit (compliance audit and financial audit) and performance audit.

Regularity audit

Regularity audit embraces for example:

- attestation of financial accountability, involving examination and evaluation of financial records and expression of opinions on financial statements. The purpose is to provide reasonable assurance that audited financial reports are free from material misstatement and are in accordance with legislation and relevant accounting standards;
- audit of financial systems and transactions, including evaluation of compliance with regulations;
- audit of internal control and internal audit functions; and
- audit of probity and propriety of administrative decisions.

⁵³ In order to achieve a secure administration, no person alone may handle a transaction throughout the chain of payments. The person who checks and authorises the invoice and the person who issues the payment order should be two different persons.

Performance audit

Performance audit, or value for money audit, embraces:

- audit of economy of administrative activities, in accordance with sound administrative principles and management policies;
- audit of efficiency of utilisation of human, financial and other resources (including examination of information systems, performance measures and monitoring) and procedures for remedying identified deficiencies; and
- audit of effectiveness of performance in relation to the achievement of objectives and actual impact compared with intended impact.

In many countries, the mandate for performance audit will stop short of review of the policy bases of government programmes. Performance audit is less developed in developing countries than regularity audit, and in many countries does not exist at all.

Risk-based audit and systems audit

Modern financial auditing is based on risk assessments, focusing the audit on areas with a high fiduciary risk. Also, systems audit is getting more attention where the appropriateness of systems for internal control is tested through examination of a sample of transactions.

1.6.2 Common Problems in Developing Countries

Weak audit institutions

Many developing countries have weak audit institutions that do not have the capability to undertake risk-based or systems audits. Also, the organisation may exist on paper but be heavily understaffed – allowing only sporadic or shallow audit interventions.

Weak PFM systems and capacity

In some countries the audit organisation and capacity may be in place – but there is little to audit in terms of annual reports and statements. A so-called unqualified annual audit report can be made short – stating that there are no financial records or statements to scrutinise and hence the audit cannot determine if any irregularities have taken place. Financial statements may be lacking for the last three years, and the ones that are forthcoming relate to transactions and budget-holders that have already left the audited organisation.

Narrow audit focus

Auditors in the partner countries often undertake regularity audit that focuses on individual transactions rather than the control systems and areas with large risks. Sometimes, internal auditors are engaged in pre-audit, which means checking that transactions have been properly processed and that funds are available – before payments are made. This is an anomaly and should form part of the organisation's internal control system – not the auditor's.

Weak response to audit reports

It is also common that the structure that is supposed to receive and act on audit reports, i.e. the audited ministry or agency and usually a parliamentary committee, is weak and has difficulties in taking appropriate action.

1.6.3 Issues for Development Partners to Consider Related to Audit

Some issues for development partners to consider are that:

- Where the audit of budget support is concerned, it is important to consider that the country's legislation may not allow any body other than the government's audit institution to audit government funds. Cooperation between development partners and the responsible government audit institution is thus important. As a rule, government representatives should always be asked to take part in audits prompted or financed by development partners, for example as a capacity development exercise.
- When development partner requirements lead to obligations for government audit institutions to conduct individual audits beyond what is required nationally, it is appropriate for development partners to consider financing the extra cost as part of the support.
- The quality of audits by local external audit firms (often represented by major multinational audit firms) is not necessarily higher than audits by government audit institutions. When hiring local external audit firms, it is appropriate to request that they can show sufficient independence and qualifications for their staff.
- Provision of budget or programme support underlines the need for effective audit institutions in recipient countries, ensuring proper use of government and development partner funds.
- In agreements on programme support, it is important to allow audits of the development partners' contributions and to agree that government audit institutions should audit the development partners' contributions using the same principles as the audit of government funds.
- It is vital to agree with the partner country's representative that all kinds of audits or follow-up reports and the background data should be available to development partners or other organisations involved.
- While both regulatory and performance auditing are important, auditing of financial transactions, internal control, and attestation of financial accountability are the most important basic requirements.
- The introduction of performance audit in an audit institution in a development country is a strategic decision for the organisation, requiring it to be prepared to set aside substantial financial resources and qualified personnel designated for the task. It also requires substantial international support.

1.7 Procurement

Purpose: To facilitate cost efficient and transparent acquisition of goods and services required for the government's service production.

Main activities: Technical specifications of required goods or services, invitations to tender, evaluation and selection of suppliers, awards of tenders and placing of orders, quality and delivery control, and evaluation.

Organisation: The degree of decentralisation of this process differs from country to country. A central supervisory unit or agency is often in place. A central tender board and/or ministerial and local tender boards are often in place to evaluate and award tenders.

Subsystems and functions and common problems in developing countries

Readers are referred to chapter 4.3.2.

Appendix 3 PFM Diagnostic Tools

- PEFA PMF, *Public Expenditure and Financial Accountability – Performance Measurement Framework*, is the most comprehensive tool for assessing the technical side of the PFM system. www.pefa.org
- HIPC assessments (*Heavily Indebted Poor Countries*) have the aim of strengthening the tracking of poverty-reducing public spending and the extent of such allocations. The assessment covered 16 benchmarks and was used in the context of the debt relief initiative by WB/IMF. <http://www.imf.org/external/np/pp/eng/2005/041205a.pdf>
- CFAA, *Country Financial Accountability Assessment*, used by the *World Bank*, partner governments and development partners to identify strengths and weaknesses of PFM arrangements leading to capacity building programmes to improve a country's PFM. <http://www.worldbank.org/>
- PER, *Public Expenditure Review*, a *World Bank* tool, which is becoming an integral part of the government budget follow-up system in many countries. It analyses a country's fiscal position, its expenditure policies (in particular in relation to pro-poor), and its public expenditure management systems. It may also examine institutional arrangements for public expenditure management, civil service reform, revenue policy and administration. PERs can also be applied at sector level. <http://www.worldbank.org/>
- CPAR, *Country Procurement Assessment Review*, CPAR, used by the *World Bank* to examine public procurement institutions and practices. <http://www.worldbank.org/>
- CPIA, *Country Policy and Institutional Assessment*, a *World Bank* tool measuring a number of indicators, including PFM. Used for decisions on IDA allocations, and as the basis for the indicator on PFM in monitoring the Paris Declaration. <http://www.worldbank.org/>
- IGR, *Institutional and Governance Reviews*, also a *World Bank* instrument, used to evaluate the quality of accountability, policy-making, and service delivery institutions. It includes diagnostics and analyses why formal systems may not be working as planned due to inadequate capacity, incentives or signals. <http://www.worldbank.org/>
- *IMF's Fiscal Transparency Assessment*, which is one module of the WB/IMF Reporting framework for Observance of Standards and Codes (ROSC) (www.imf.org).
- *Methodology for Assessment of National Procurement Systems* (Version 4 – draft June 2006) is a new comprehensive tool developed by the OECD DAC working party on aid effectiveness. This tool is expected to replace CPAR. www.oecd.org/dac
- CONTACT, *Country Assessment in Accountability and Transparency*, is a comprehensive assessment battery of questions used by UNDP. (www.undp.org)

There are also a number of standards and codes for best practices in the PFM field. These can be used to a certain extent to determine the standard followed by a specific country. Examples of these are:

- INTOSAI – *International Organisation of Supreme Audit Institutions* with its Lima declaration on audit precepts, auditing standards and guidelines for internal control standards (www.intosai.org).
- *Institute of Internal Audit* issues standards that can be found at <http://www.theiia.org/ia>.
- IFAC – PSC (*International Federation of Accountants' Public Sector Committee*) has issued a number of IPSAS – *International Public Sector Accounting Standards*. www.ifac.org.
- GFS – *Government Finance Statistics* with manuals issued by the IMF, gives guidelines for governmental reporting of revenue and expenditure according to nature or expenditure and revenue items as well as reporting and classification of assets and liabilities (www.imf.org).
- COFOG, the UN *Classification of the Functions of Government*, is a classification of *Government Expenditure* according to purpose. (www.undp.org)

Appendix 4 Glossary

- Accountability* Obligation to demonstrate that work has been conducted in compliance with agreed rules and standards or to report fairly and accurately on performance results vis-à-vis mandated roles and/or plans (DAC).
- Accounting Officers* Officials who have the ultimate responsibility or accountability for a vote.
- Administrative decentralisation* (deconcentration/delegation/devolution) The transfer of administrative powers, and sometimes administrative personnel, from higher to lower levels in the political system.
- Aid Modality* The instrument used to support a programme and the mode of co-operation associated with it. Aid modality is wider concept than the financing modality (see below) insofar that it normally defines the scope of the contribution in relation to the programme and entails institutional arrangements/working procedures. *General Budget Support* is thus an aid modality normally used to support the PRS through the financing modality budget support, whereas *Sector Budget Support* is the aid modality used if the programme (supported by budget support) relates to a specific sector in terms of financed dialogue and follow-up.
- Alignment* Development partners base their overall support on partner countries' national development strategies, institutions and processes (Paris Declaration).
- Audit* An independent, objective assurance activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to assess and improve the effectiveness of risk management, control and governance processes (DAC).
- Basket funding* Basket funding is the joint funding by a number of development partners of a set of activities through a common account, which keeps the basket resources separate from all other resources intended for the same purpose. The planning and other procedures and rules governing the basket fund are therefore common to all participating development partners, but they may be more or less in conformity with the public expenditure management procedures of the partner government. A basket may be earmarked for a narrow or wide set of activities (e.g. a sector or a sub-sector). The term "pool(ed) funding" is sometimes used instead of basket funding.

<i>Below-the-line items</i>	The items that are below the line drawn to establish the deficit between revenues and expenditures. “Below-the-line” thus normally relates to the financing of deficits.
<i>Budget Support</i>	Financial support from a development partner that is channelled into the general treasury account of a recipient country where, as an integral part of the resources herein, it co-funds the national budget. The support is normally not earmarked financially, and it is used according to the national public expenditure management rules and procedures.
<i>Capital Budget</i>	The capital side of the budget contains investments and other costs which are one-off, whereas the recurrent budget is for operating the public sector and maintaining investments. The capital budget is sometimes called the development budget.
<i>Capital Expenditures</i>	Expenditures on one-off items such as a new building, also referred to as investments.
<i>CFAA</i>	Country Financial Accountability Assessment. Assessment of both public and private sector financial accountability systems and professional standards.
<i>Contingent liabilities</i>	Represents a potential future draw on government resources. As they are not certain they pose a risk.
<i>Country Assistance Strategy (CAS)</i>	The World Bank’s central tool for overseeing and piloting its country programmes for IDA and IBRD borrowers.
<i>CPAR</i>	Country Procurement Assessment Report. Assessment of public procurement systems and standards.
<i>CPIA</i>	Country Policy and Institutional Assessment. Covers a wide range of indicators of governance, including PFM. Used by the World Bank to allocate IDA resources and for follow-up of the indicators on PFM in the Paris Declaration on Aid Effectiveness.
<i>Decentralisation</i>	The dispersion or distribution of functions and powers, specifically the delegation or devolution of power from a central authority to regional and local authorities.
<i>Democratic decentralisation</i>	The transfer of resources (including financial and administrative resources) and powers (including decision-making powers, and sometimes revenue-raising powers) from higher levels in political systems to elected bodies at lower levels
<i>Development Assistance Committee (DAC)</i>	Department in the OECD (Organisation for Economic Co-operation and Development) that handles cooperation issues related to developing countries. DAC is responsible for coordination, integration, promoting effectiveness and providing sufficient funding for development assistance in support of sustainable economic and social development.

<i>Developmental Risk</i>	The risk that developmental objectives are not reached. This is a crucial aspect in assessing whether to align with government systems or not. Developmental risk may point to using systems although fiduciary risk is high.
<i>Effectiveness</i>	The extent to which the development intervention's objectives were achieved, or are expected to be achieved, taking into account their relative importance (DAC).
<i>Efficiency</i>	A measure of how economically resources/inputs (funds, expertise, time, etc.) are converted into results (DAC). Efficiency, thus, means comparing outputs to inputs.
<i>Fiduciary risks</i>	The risk that funds are not used for intended purposes, do not achieve value for money, or are not properly accounted for.
<i>Financing Modalities</i>	The way the funds are channelled to the activities to be funded. A basic distinction can be made between 1) budget support (which is integrated into the national budget of the recipient country and used according to national public expenditure management rules and procedures), and 2) parallel support (which is kept separate from the general resources in the national budget but should still be reflected in the national budget, and which is used according to rules and procedures that may be more or less in conformity with those laid down in the national public expenditure management system).
<i>Fiscal decentralisation</i>	The transfer of funds and/or revenue-raising powers from higher levels to lower levels in political systems (which include both administrative structures and elected bodies).
<i>Fungibility</i>	The fact that funds are replaceable. As a consequence, the provision of funds to one expenditure area may release the corresponding amount from that area to be used for other purposes.
<i>Harmonisation</i>	Development partner actions are more harmonised, transparent and collectively effective (Paris Declaration).
<i>Heavily Indebted Poor Country (HIPC)</i>	First launched in 1996 by the IMF and World Bank with the aim of ensuring that no poor country faces a debt burden it cannot manage. The initiative entails coordinated action by the international financial community, including multilateral organisations and governments, to reduce to sustainable levels the external debt burdens of the most heavily indebted poor countries.
<i>Impacts</i>	Primary and secondary long-term effects produced by a development intervention, directly or indirectly, intended or unintended (DAC).
<i>Indicator</i>	Quantitative or qualitative factor or variable that provides a simple and reliable means to measure achievement, to reflect the changes connected to an intervention, or to help assess the performance of a development actor (DAC).

<i>Inputs</i>	The financial, human, and material resources used for a development intervention (DAC).
<i>Joint Financing Arrangement (JFA)</i>	An agreement between a number of development partners and a recipient government specifying how development partners may jointly finance a programme or set of activities.
<i>Lead donor</i>	A development partner donor given the authority, but not formal decision-making powers, to act on behalf of other development partners in a sector or thematic area. A lead development partner arrangement can be more or less well defined and is only sometimes described in an Memorandum of Understanding (MoU) or Terms of Reference or similar.
<i>Logical Framework Approach (LFA/Logframe)</i>	Management tool used to improve the design of interventions, most often at the project level. It involves identifying strategic elements (inputs, outputs, outcomes, impact) and their causal relationships, indicators, and the assumptions or risks that may influence success and failure. It thus facilitates planning, execution and evaluation of a development intervention (DAC).
<i>Managing for Results</i>	Managing and implementing aid in a way that focuses on the desired results and uses information to improve decision-making (Paris Declaration).
<i>Medium-Term Expenditure Framework (MTEF)</i>	Forward medium-term (typically three to five years) estimates of the costs (integrating recurrent and capital spending) of existing policies and proposed policy changes subjected to explicit aggregate fiscal ceilings.
<i>Monitoring</i>	A continuous function that uses systematic collection of data on specified indicators to provide management and the main stakeholders of an ongoing development intervention with indications of the extent of progress and achievement of objectives and progress in the use of allocated funds (DAC).
<i>Needs and Capacity Assessments</i>	A tool that draws out information about people's varied needs, raises participants' awareness of related issues, and provides a framework for making priorities among development needs.
<i>Nordic+</i>	A group of like-minded development partners (Norway, Sweden, Finland, UK, Ireland, the Netherlands and Denmark). Meets at Director General level twice a year (together with Iceland). The group has a Joint Action Plan on harmonisation and alignment and sub-groups on a number of issues, some of which include other development partners as well: procurement (includes Germany and Canada), Joint Financing Arrangements (includes Canada). Nordic+ countries work together also at country level in different and often more loosely defined groupings.
<i>Outcome</i>	The likely or achieved short-term and medium-term effects of an intervention's outputs (DAC).

<i>Outputs</i>	The products, capital goods and services which result from a development intervention; may also include changes resulting from the intervention which are relevant to the achievement of outcomes (DAC).
<i>Ownership</i>	Partner countries exercise effective leadership over their development policies and strategies and coordinate development actions (Paris Declaration).
<i>Parallel aid</i>	Aid which does not become part of the general treasury account and cannot be disbursed through the ordinary government channels through which the MoF finances the spending units.
<i>Paris Declaration on Aid Effectiveness</i>	An international agreement to improve aid effectiveness and be held accountable by a series of indicators and targets as a way of combating poverty in developing countries. Endorsed on 2 March 2005 at the Second High Level Forum on Aid Effectiveness
<i>PEFA</i>	Public Expenditure and Financial Accountability. Internationally agreed methodology for the assessment of recipient country public expenditure and financial accountability systems.
<i>PER</i>	Public Expenditure Review. Review of policy and public expenditures, either by sector or in multiple sectors. PERs are typically carried out by or with the participation of the World Bank. A PER may also look at expenditure management systems, but this part is expected to be replaced by PEFA.
<i>Performance Assessment Framework (PAF)</i>	A limited set of well-defined indicators and reform issues which is agreed by the development partners and the partner country as the basis for dialogue, monitoring and performance evaluation of a programme.
<i>Performance Management Framework</i>	A framework including well-defined objectives and targets for performance management and a series of tools to be used to collect the information necessary.
<i>Pool(ed) funding</i>	See Basket Funding.
<i>Poverty Reduction Strategy (PRS)</i>	Describes a country's overall strategy to promote growth and reduce poverty, as well as associated external financing needs. Governments prepare PRSs ideally through a participatory process involving civil society and development partners.
<i>Poverty Reduction Support Credits (PRSCs)</i>	A series of annual programmatic development loans (budget support) to support implementation of a country's Poverty Reduction Strategy, with clear performance benchmarks, including results indicators and policy measures within the areas of the World Bank's primary responsibility.
<i>Programme</i>	A time-bound intervention involving multiple activities that may cut across sectors, themes and/or geographic areas (DAC).

<i>Programme-Based Approach</i>	An approach based on the principle of coordinated support for a locally owned programme of development, such as a national poverty reduction strategy, a sector programme, a thematic programme or a programme of a specific organisation (Learning Network on Programme Based Approaches, definition adopted by DAC).
<i>Project</i>	An individual development intervention designed to achieve specific objectives within specified resources and implementation schedules, often within the framework of a broader programme (DAC).
<i>Recurrent Budget</i>	The part of the state budget that sets aside resources for the daily operations of the public sector (salaries, maintenance of investments, school books, etc.).
<i>Recurrent Expenditures</i>	Expenditures for the daily operation of the public sector (salaries, maintenance of investments, school books, etc.).
<i>Relevance</i>	The extent to which the objectives of a development intervention are consistent with beneficiaries' requirements, country needs, global priorities, and partners' and development partners' policies (DAC).
<i>Results</i>	The output, outcome or impact of a development intervention (DAC).
<i>Results-Based Management (RBM)</i>	A management strategy focusing on performance and achievement of outputs, outcomes and impacts (DAC).
<i>Risk Analysis</i>	An analysis or an assessment of factors (called assumptions in the logframe) that affect or are likely to affect the successful achievement of an intervention's objectives (DAC).
<i>Sector</i>	A coherent set of activities which can be relevantly distinguished in terms of policies, institutions and finances, and which need to be looked at together to make a meaningful assessment.
<i>Sector budget support</i>	Financial support from a development partner that is channelled into the general treasury account of a recipient country where, as an integral part of the resources herein, it co-funds the national budget, but dialogue and follow-up focuses on the sector.
<i>Sector Wide Approach (SWAp)</i>	A programme-based approach operating at the level of an entire sector (DAC).
<i>Steering Committee</i>	Decision-making body above the daily management level, established for the purpose of joint management by the partner, Sida and other development partners.
<i>Sustainability</i>	The continuation of benefits from a development intervention after major development assistance has been completed (DAC).
<i>Target Group</i>	The specific individuals or organisations for whose benefit the development intervention is undertaken (DAC).

<i>Transaction Costs</i>	The direct and indirect costs incurred by aid providers and recipients, which are specifically associated with the management of aid and the aid partnership generally. Costs may be in terms of funds, time, use of resources, efficiency losses, etc. Often, the term is used particularly about the transaction costs on the recipient side.
<i>Validity</i>	The extent to which the data collection strategies and instruments measure what they purport to measure (DAC).
<i>Virement</i>	the process of transferring expenditure provision between expenditure classifications during the budget year. To prevent misuse of funds, spending agencies must often require permission to make such transfer.
<i>Vote</i>	A group of appropriations. Each ministry or department will consist of one or more votes.
<i>Warrants</i>	A release of all, or more commonly a part, of the total annual appropriation that allows a line ministry or spending agency to incur commitments.
<i>Working Party on Aid Effectiveness (WP EFF)</i>	The international grouping of development partners and partner countries that oversees the implementation of the Paris Declaration. It has a number of sub-groups (Joint Ventures) on Public Finance Management, Procurement, Managing for Development Results and Monitoring the Paris Declaration.

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Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.



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