“Governments across the world are constantly searching for ways to improve their public financial management systems. This impressive book covers many of the questions that get asked in this search. It offers insightful perspectives on the challenges of managing public money and will inspire and inform reform ideas across the globe for years to come. Academics and practitioners alike should keep a copy close at hand. I certainly will.”

Matt Andrews, Associate Professor of Public Policy, Kennedy School of Government, Harvard University; author of *The Limits of Institutional Reforms in Development: Changing Rules for Realistic Solutions*

“Faced with growing debt and an uncertain macroeconomic outlook, many governments are experimenting with institutional innovations such as new budgetary rules and fiscal councils. Yet the naïve import of reforms has uncertain benefits. This much-needed book seeks to avoid simplistic prescription, and fosters awareness of the coherence and context of budget institutions. It is an indispensable guide for postcrisis fiscal designers.”

Joachim Wehner, Associate Professor of Public Policy, London School of Economics and Political Science; author of *Legislatures and the Budget Process: The Myth of Fiscal Control*

“This timely volume helps us all better understand the bow wave of public financial and fiscal policy reforms that have been initiated by thoughtful practitioners in nations around the world. Thanks to the chapters by leading public finance analysts, we now have a comprehensive conceptual framework to assess the practices adopted by individual nations, often in the heat of a financial crisis. This couldn’t come at a better time, as leaders and analysts alike will need better guideposts to help nations achieve more sustainable and rationalized public finances in the tumultuous years to come.”

Paul L. Posner, Director, Public Administration Program, George Mason University

“This helpful volume analyzes the key public financial management innovations that took place over the past two decades. Grouping these innovations loosely into three categories—information, processes, and rules—the authors argue that public financial management is an integrated framework with its own architecture, logic, and connections. There may not therefore be a direct link between individual innovations and outcomes, and general advice is not likely to fit any specific country. The book also poses some intriguing questions, such as what is the likelihood that innovations developed in more advanced economies will work in developing countries.”

Irene S. Rubin, Professor Emeritus of Public Administration, Northern Illinois University; former editor-in-chief, *Public Administration Review*; author of *The Politics of Public Budgeting and Balancing the Federal Budget: Eating the Seed Corn or Trimming the Herds*
“In the wake of the financial crisis public resources are particularly scarce. Thus, effective and efficient use of taxpayers’ money requires sound financial management and full transparency: citizens, parliaments, and financial markets deserve a clear picture of where public finances stand. This book provides an impressive overview of country practices, reforms and innovations in the area of public financial management. This timely publication is a rich source for practitioners in public administrations as well as for the academic community and the interested public.”

Gerhard Steger, Director General of the Budget, Austrian Ministry of Finance; Chair, OECD Working Party of Senior Budget Officials

“The most comprehensive and informative guide on public financial management! It is well-timed as well. I certainly believe that it will be well received in the Asian region, including Korea, where the importance of PFM is being recognized more than ever.”

Won-Dong Cho, President, Korean Institute of Public Finance

“In this comprehensive survey of current trends in public financial management, the authors present and analyze PFM instruments and practices from around the world. Their analysis is firmly empirical, based on a broad spectrum of sources, and the presentation is balanced; no reader is left with the impression that sophisticated techniques can replace political commitments and hard work. This anthology will for a long time remain a rich source of information for both practitioners in ministries of finance and academic researchers.”

Per Molander, former Director-General; architect of Swedish budget reform of the 1990s
Public Financial Management and Its Emerging Architecture

EDITORS
Marco Cangiano, Teresa Curristine, and Michel Lazare
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Public financial management (PFM)—the fine art of budgeting, spending, and managing public monies—has undergone a “revolution” since the late 1980s. This uniquely interdisciplinary combination of economics, political science, public administration, and accounting has seen an influx of innovative ideas and reforms that have sought to address some of the perennial challenges of managing public finances.

To constrain the likely temptation to increase expenditure and spend, rather than save, in times of plenty, countries have introduced fiscal rules and fiscal responsibility laws. To understand and plan for the impact of today’s policy choices on finances in the years ahead, governments have adopted medium-term budget frameworks. To help guard against over-optimistic economic and budgetary estimates, some countries have established independent fiscal councils. To shift the focus of decision making from how much money programs receive to the results they can achieve, many governments have introduced performance budgeting and management initiatives. To better understand the true state of public finances and underlying risks, some governments have sought to increase the comprehensiveness and coverage of fiscal reporting and accounting and have introduced risk management techniques. This profound wave of change in the ways public spending is managed largely started in Australia, New Zealand, and the United Kingdom and has since then passed through virtually all advanced economies, and to some extent, has also reached emerging market economies and low-income countries.

While the field of PFM has changed dramatically over the last two decades, very little has been written about this revolution, with the exception of a few specialized articles. In filling this gap in the literature, this book takes advantage of the unique perspectives provided by IMF public financial management experts, who, over the last two decades, have gained practical experience with many if not all of these reforms and are well placed to draw lessons, make sense of the PFM revolution, and share their cross-country experiences of what has worked in practice and what has not.

The book poses critical questions about these reforms and evaluates what they have accomplished and the issues and challenges they have encountered, including with the global financial and economic crisis. The crisis highlighted the critical importance of a sound public financial management framework in ensuring that well-designed fiscal policies are effectively implemented. But it also demonstrated the underlying limitations of some countries’ PFM frameworks and the flawed design and weak implementation of some PFM innovations, as well as their failure to entrench themselves. Based on these experiences, this book draws general lessons to help guide reformers in their pursuit of the next generation of PFM reforms.
The IMF remains committed to working with all its member countries to provide advice and assistance on public financial management, drawing on its deep experience of working on these issues all over the world. I hope that this publication will help countries meet the challenges of managing public finances in an increasingly complex and uncertain global environment.

Christine Lagarde
Managing Director
International Monetary Fund
Acknowledgments

The idea for this book came from a conversation with Professor Allen Schick in which we discussed how public financial management has developed over the past two decades. Subsequent conversations led to the conclusion that Professor Schick and the staff of the IMF’s Fiscal Affairs Department had rich and unique academic and practical experiences to share on how public financial management reforms have evolved and the emerging state of the discipline at the beginning of the twenty-first century. Special recognition goes to Professor Schick for his role in propelling the project and acting as a sounding board for all of us.

This book was a joint effort involving the staff of the two Public Financial Management Divisions of the Fiscal Affairs Department. A large number of friends and former colleagues contributed by reviewing and commenting on various versions of the chapters as well as by participating in a number of lively internal seminars. The work of the entire Fiscal Affairs Department, under the leadership of its Director, Carlo Cottarelli, has provided a stimulating environment in which parallel projects have kept our eyes open, particularly to the views of the nonspecialists. There was, however, no substitute for the many interactions with member countries and colleagues from sister institutions. These interactions provided a much-needed reality check as the elements of the public financial management architecture started to emerge. Participating compatriots included past and present generations of public financial management specialists of the Fiscal Affairs Department, who have generously given us their time, wisdom, and experience, in an attempt to make this book accessible to the uninitiated. In addition to the chapter authors and the staff of the two Public Financial Management divisions, we wish to thank the reviewers, Xavier Debrun, Manal Fouad, Greg Horman, Bacari Kone, Florence Kuteesa, Lewis Murara, Peter Murphy, Sailendra Pattanayak, Mario Pessoa, Dimitar Radev, and Xavier Rame, for their insightful comments and suggestions. We also wish to express our gratitude to our administrative assistants Molly Abraham, Tracy Bowe, Veronique Catany, and Sasha Pitrof for their support, and especially Melinda Weir, who was instrumental in bringing the project to completion. We are very grateful to Michael Harrup of the IMF’s External Relations Department for coordinating the production of the book. We thank all of you and especially our families and friends for their patience and support throughout this project.

Marco Cangiano, Teresa Curristine, and Michel Lazare
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>CBA</td>
<td>central budget authority</td>
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<tr>
<td>CBO</td>
<td>Congressional Budget Office (United States)</td>
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<td>CEMAC</td>
<td>Central African Economic and Monetary Community</td>
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<tr>
<td>CFI</td>
<td>central fiscal institution</td>
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<td>CMU</td>
<td>cash management unit</td>
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<td>CPIA</td>
<td>Country Policy and Institutional Assessment</td>
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<tr>
<td>DMO</td>
<td>debt management office</td>
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<tr>
<td>ECCU</td>
<td>Eastern Caribbean Currency Union</td>
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<td>EITI</td>
<td>Extractive Industries Transparency Initiative</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<td>FMIS</td>
<td>financial management information system</td>
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<tr>
<td>FRL</td>
<td>fiscal responsibility law</td>
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<tr>
<td>G-8</td>
<td>Group of Eight advanced economies</td>
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<td>G-20</td>
<td>Group of Twenty advanced economies</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<td>GDP</td>
<td>gross domestic product</td>
</tr>
<tr>
<td>HIPC</td>
<td>Heavily Indebted Poor Countries</td>
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<tr>
<td>IFI</td>
<td>international financial institution</td>
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<tr>
<td>IPSAS</td>
<td>International Public Sector Accounting Standards</td>
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<tr>
<td>IT</td>
<td>information technology</td>
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<tr>
<td>MTBF</td>
<td>medium-term budget framework</td>
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<td>MTDS</td>
<td>medium-term debt management strategy</td>
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<td>MTFF</td>
<td>medium-term fiscal framework</td>
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<td>NCoA</td>
<td>National Commission of Audit (Australia)</td>
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<td>NDP</td>
<td>national development plan</td>
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<td>NPM</td>
<td>new public management</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>PB</td>
<td>performance budgeting</td>
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<td>PEFA</td>
<td>Public Expenditure and Financial Accountability</td>
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<td>PFM</td>
<td>public financial management</td>
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<td>PI</td>
<td>performance information</td>
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<td>PIP</td>
<td>public investment program</td>
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<td>PPP</td>
<td>public-private partnership</td>
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<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>ROSC</td>
<td>Report on the Observance of Standards and Codes</td>
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<td>RRA</td>
<td>resource revenue account</td>
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<tr>
<td>SGP</td>
<td>Stability and Growth Pact</td>
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<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
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<td>T-bill</td>
<td>treasury bill</td>
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<td>TSA</td>
<td>treasury single account</td>
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<tr>
<td>UN</td>
<td>United Nations</td>
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<tr>
<td>VAR</td>
<td>value at risk</td>
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<td>WAEMU</td>
<td>West African Economic and Monetary Union</td>
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INTRODUCTION

The Emerging Architecture of Public Financial Management

MARCO CANGIANO, TERESA CURRISTINE, AND MICHEL LAZARE

If a single word could encapsulate public financial management (PFM) in the first decades of the twenty-first century, it would be innovation. This book takes stock of key, groundbreaking practices that have emerged over the past two decades in this uniquely interdisciplinary field, including, among others, fiscal responsibility laws, fiscal rules, medium-term budget frameworks, fiscal councils, new fiscal risk management techniques, and performance budgeting. It evaluates what these innovations have accomplished and how they have changed the way we think of PFM—from how governments administer their budgets to how they manage their fiscal policy and public finances. The aim of the book is to sketch the elements of PFM and highlight their interdependence, while being accessible to as broad an audience as possible, but in particular to policymakers who must deal with the increasing complexity of managing public resources.

Although the book was conceived and written in the midst of a grave financial crisis, it is not about the crisis. Nor is it a PFM handbook or manual, which would merely describe PFM practices. Rather, this book poses critical questions about innovations, what has been achieved, the issues and challenges that have appeared along the way, and how the ground can be prepared for the next generation of PFM reforms. The focus is mainly, but not exclusively, on advanced economies—where most of the innovations discussed in this book originated. Innovation has always been an aspect of PFM. The current wave of reforms is different, however, because of the sheer volume and pace of innovations, their widespread adoption, and the sense that they add up to a fundamental change in the way governments manage public money.

WHAT IS PUBLIC FINANCIAL MANAGEMENT? AN EVOLUTIONARY DEFINITION

PFM in the narrowest, and perhaps most traditional, sense is concerned with how governments manage the budget in its established phases—formulation, approval, and execution. It deals with the set of processes and procedures that cover all aspects of expenditure management in government. It is also interdisciplinary, drawing from economics, political science, and public administration, as well as accounting and auditing. But as its relevance in fiscal policymaking has evolved
over time, so has its definition. The simple passage from expenditure to financial management has broadened its focus from the narrowly defined budget to all aspects of managing public resources, including resource mobilization and debt management, with a progressive extension to the medium- to long-term implications and risks to public finances from today's policy decisions. The coverage of PFM has thus expanded from the narrowly defined central government budget to all levels of government and the broader public sector, including state enterprises and public-private partnerships.

Furthermore, PFM is now seen as an “umbrella” definition, covering a set of systems aimed at producing information, processes, and rules that can help support fiscal policymaking as well as provide instruments for its implementation. Having in place inappropriate budgetary processes and rules can cause unsustainable increases in expenditure and unbudgeted liabilities. Poor or nonexistent financial information, as can result from unrealistic projections of economic growth or nondisclosure of fiscal risks, can undermine government finances. It is this linkage of policies and processes that highlights the importance of PFM and has stimulated recent innovations in PFM practices. That said, PFM is not a substitute for fiscal policymaking; it cannot provide answers to questions about the optimal level of public indebtedness, the proper size of government, and the fair distribution of resources.

The key objectives of public financial management—maintaining a sustainable fiscal position, the effective allocation of resources, and the efficient delivery of public goods and services—have long been established in the literature. The emphasis of this book is on the set of systems, processes, and rules that can counter the well-documented deficit bias inherent in the political process. As the book argues, information on past, current, and future fiscal developments is of paramount importance in this regard—without sustainable public finances, effectiveness and efficiency run the risk of becoming secondary objectives. In this respect, PFM has certainly evolved from its traditional focus on financial compliance and control to become a key foundation for macrofiscal analysis and policymaking.

It is important to dispel a potential misunderstanding of the meaning of the first PFM key objective, maintaining a sustainable fiscal position. This objective should not be seen as, and certainly does not imply, a bias toward fiscal tightening. It is a way to achieve legitimate macroeconomic objectives, most notably inclusive and balanced growth, in an orderly fashion without prejudging the state of public finances, which may, in turn, have negative repercussions on macroeconomic stability and growth.

---

1 Since the early 1990s, these objectives have been the standard PFM objectives used in academia and by the IMF and the World Bank and other international financial institutions.

2 The deficit (and debt) bias has been analyzed and explained by various authors as a common pool resource problem (Weingast, Shepsle, and Johnsen, 1981), a prisoners’ dilemma (Hallerberg and von Hagen, 1997), time inconsistency and principal-agent relationships (Kydland and Prescott, 1977).
PURPOSE OF THIS BOOK

The objective of this book is to assess selected PFM innovations and reforms introduced during the past 20 years. It aims to explain how reforms have worked; to examine the issues that have emerged in their design and implementation; to compare experiences with expectations; and to provide an understanding of how differences in government capacity affect PFM initiatives. The hope is that readers will take away an enhanced understanding of the prospects and problems associated with contemporary PFM reform.

The PFM literature has grown rapidly in this period, but it is fairly specialized and addresses a specific audience. Very few attempts have been made to take stock of how PFM has evolved over the last two decades. This period has also seen the introduction of a number of PFM diagnostics, most notably the 1998 IMF Code of Good Practices on Fiscal Transparency, with the associated diagnostic, Reports on the Observance of Standards and Codes (ROSCs), and the 2002 Public Expenditure and Financial Accountability (PEFA) assessment. It is also somewhat surprising—and disappointing—that despite the hundreds of thousands of civil servants and practitioners involved in this area around the globe, PFM is virtually absent from any economics or even public finance curricula; a multitude of specialized courses can be found in political science or public administration, and in accounting, auditing, and project evaluation, but very few attempt to bring together the interdisciplinary approach modern PFM requires. This book attempts to fill this gap in the literature.

What are the key PFM innovations discussed in this book? They include, among others, new legal frameworks to promote fiscal responsibility, fiscal rules, medium-term budget frameworks (MTBFs), fiscal councils, new fiscal risk management techniques, performance budgeting, and accrual reporting and accounting. How have these reforms emerged over the past two decades? Some general facts and trends about their development are highlighted in the following:

- The number of countries with fiscal rules rose from 5 in 1990 to 76 in 2012.
- The number of countries with MTBFs increased from fewer than 20 in 1990 to more than 130 in 2008.

---

1 Pretorious and Pretorious (2008) provide a comprehensive review of PFM literature, but are mainly focused on the vexata quaestio of how best to sequence PFM reforms in developing countries. See also Diamond (2012a) for a contribution to this topic.

2 Many handbooks and manuals were published in the late 1990s and early 2000s, largely driven by the need to deal with transition economies. See Premchand (1993); Schick (1998); Allen and Tomassi (2001); World Bank (1998); Porter and Diamond (1999); and Schiavo-Campo and Tomassi (1999).

3 The IMF’s Code and associated Manual on Fiscal Transparency were issued in 1998, modified in 2007 (see IMF, 2007), and substantially revised in 2013. The PEFA program was founded in 2002 as a multidonor partnership between the European Commission, the IMF, the World Bank, the French Ministry of Foreign and European Affairs, the Norwegian Ministry of Foreign Affairs, the Swiss State Secretariat for Economic Affairs, and the U.K. Department for International Development. Its aim is to assess the performance of public expenditure, procurement, and financial accountability systems.
• The number of countries with fiscal councils grew from about 6 in 1990 to about 25 in 2013. A sharp increase has occurred recently, with ten or more such councils having been created since 2008.\(^6\)

• With the emergence of new fiscal reporting standards, the number of countries reporting at least a financial balance sheet to the IMF increased from 21 in 2004 to 41 in 2011.

• By 2007, 80 percent of Organisation for Economic Co-operation and Development (OECD) countries produced performance information, and in 2011 nearly 70 percent had a standard performance budgeting framework.

• Since 1999, 111 “Fiscal Transparency ROSCs” have been conducted, covering 94 countries, and by the end of 2012, 285 PEFA assessments had been undertaken, covering 135 countries.\(^7\)

The word *architecture* is used in the title of this book to convey how PFM elements are interconnected and mutually dependent and how they can be melded into a comprehensive structure. Borrowing from Premchand’s analogy, PFM is “like weaving a Persian carpet, where every tiny knot is as important as the grand design itself” (Premchand, 1993, p. 6). *Emerging* points to the fact that the past 15–20 years have seen the adoption of a number of innovations, some of which have now become part of the PFM lexicon, whereas others have been abandoned and others are still being tested. It also emphasizes the time dimension, given that innovations require lengthy gestation and implementation phases; it stresses how PFM is an open system in which waves of innovation are bound to take place at irregular intervals as the demand for better management of public resources increases. Finally, *emerging architecture* implies that the focus of this book is on the selected elements that have emerged in the last two decades and can now be seen as building blocks of modern PFM—along with others that are not specifically covered in this book but are also important.\(^8\)

Looking at PFM as an integrated framework or system can illuminate important issues. For instance, when reforms are launched in isolation from one another, interested governments may not be aware of their interdependence.\(^9\)

Viewed in isolation, each innovation has its own constituency, terminology,\(^6\)

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\(^6\)This is the number of fiscal councils as of February 2013. For more details see the IMF Fiscal Council Database (forthcoming), as well as IMF (2013).

\(^7\)For more details on the ROSCs, see IMF (2012). In 2013, the IMF substantially revised the Code of Good Practices on Fiscal Transparency and the corresponding diagnostic tool, the ROSC. A revised ROSC is due to be launched at the end of 2013.

\(^8\)Essential aspects of PFM that are more focused on budget execution, such as treasury single account, commitment control and reporting, and government financial management information systems, have been developed and implemented for some time. Nonetheless, they remain critical because quite a number of countries still lack these essential features of the PFM armory. Besides the manual referenced in note 5, short and accessible material on these aspects can be found in the Technical Notes and Manuals series the IMF Fiscal Affairs Department has been producing for the last few years. They are all available via the IMF PFM blog at http://blog-pfm.imf.org/.

\(^9\)For instance, information contained in financial statements helps in compliance with fiscal rules; changing the basis of budgetary controls from input to output can promote efficiency in the delivery of public goods and services.
information requirements, and procedures that may get in the way of others. This is when government expectations for improvement are frustrated, leading to administrative overload and reform fatigue. Properly designed, an integrated PFM agenda can highlight interdependencies among elements and enable government to select the course that fits its needs and capacity. The system frame of reference also highlights the persisting tendency among public finance specialists and policymakers to split policy design from implementation. In modern and increasingly complex economies, one cannot be conceived without the other.

Finally, advanced economies have been fertile breeding grounds for PFM innovations, but low-income countries have been the main venues for comprehensive reform efforts. The profound differences among countries do not mean that PFM improvements are beyond the reach of countries beset by significant shortcomings. The differences do suggest, however, that innovators should be mindful of sequencing issues and capacity constraints. Architecture is always important; in low-capacity countries, it is critical.10

PUBLIC FINANCIAL MANAGEMENT IN THE WAKE OF THE FINANCIAL CRISIS

The ongoing financial and economic crisis has proved to be quite a test for PFM. It has revealed how many reforms were far from being well entrenched. For instance, expenditure control mechanisms turned out to be weaker in practice than expected, and some countries in financial distress saw expenditure arrears increase very rapidly. Numerical fiscal rules and targets have proliferated in the past 15 years, and have often been seen as a means for addressing all fiscal problems—chiefly rising deficits and debt levels but also accountability and responsibility gaps—while relegating other vital PFM elements to a supporting role (Wyplosz, 2012). But the record to date is far from compelling, with the overall lackluster performance of numerical rules that were introduced in isolation rather than as part of a more coherent expenditure framework. It is most welcome and timely that the European Commission has focused on other essential PFM elements as part of its Fiscal Compact.11

The crisis has focused attention on two aspects of PFM that have been somewhat neglected in the last two decades but are at its very core: budgetary institutions and fiscal transparency. A well-established body of theoretical and

10 It is important to stress that there is no automatic relationship between low capacity and low income. Certain advanced economies have revealed, particularly in the wake of the financial crisis, lower-than-expected PFM capacity, whereas capacity in a number of emerging market economies and even low-income countries has been growing quite rapidly.

11 On December 13, 2011, the reinforced Stability and Growth Pact entered into force with a new set of rules for economic and fiscal surveillance. These new measures, the so-called Six Pack, comprise five regulations and one directive proposed by the European Commission and approved by all 27 member states and the European Parliament in October 2011. The Six Pack was followed in March 2012 by the intergovernmental agreement—not an EU law—the Treaty on Stability, Coordination and Governance, the fiscal part of which is commonly referred to as the Fiscal Compact. The treaty is binding for all euro area member states.
empirical analysis shows how budgetary institutions can influence fiscal outcomes. From the perspective of this book, institutions are defined as the laws, procedures, rules, and conventions—including the bodies created by those norms—that influence fiscal policy decision making and management. Strong institutions can improve fiscal performance by highlighting the need for sustainable policies, exposing the full cost of public interventions, and raising the cost of deviating from stated fiscal objectives. By increasing the credibility of announced policies, strong institutions can also foster more favorable macroeconomic conditions and improve market confidence, which further support the restoration of fiscal sustainability.

Key among the institutional arrangements are those that allow governments to have a full understanding of the current state and future evolution of the public finances, including exposure to contingent risks. But some governments are simply unaware of their true fiscal state and the exposure of their public finances for sheer lack of available information, despite concerted efforts to develop a set of internationally accepted standards for fiscal reporting and to monitor and promote the implementation of those standards at the national level. Thus, the understanding of many governments’ underlying fiscal positions and the risks to the fiscal positions remains inadequate.

As discussed in a recent IMF paper (IMF, 2012), the financial crisis revealed that, even among advanced economies, governments’ understanding of their current fiscal position was inadequate, as shown by the emergence of previously unrecorded deficits and debts and the crystallization of large, mainly implicit, government liabilities to the financial sector. To paraphrase Rajan (2010), public finances were also sitting on fault lines largely because governments had substantially underestimated the risks to their fiscal prospects. Finally, the sharp deterioration of the fiscal stance that accompanied the crisis and the related need for fiscal adjustment have increased the incentives for governments to engage in activities that cloud the true state of their finances. As argued in quite a few chapters of this book, much remains to be done in this area because fiscal reports can be manipulated, thus circumventing fiscal rules and objectives.

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12 Positive causality between the quality of budget institutions and fiscal outcomes has been demonstrated in numerous studies covering countries with different income levels, constitutional systems, and geographical locations. See, for example, von Hagen (1992); von Hagen and Harden (1996); Alesina and others (1999); de Haan, Moessen, and Volkerink (1999); and Debrun and others (2008).

13 Although well beyond the purposes of this book, it may not be sheer coincidence that the debate on the role of institutions in generating growth and alleviating poverty has been reinvigorated in the last few years. See, for instance, Acemoglu and Robinson (2012) and the comments it has generated by, for instance, Sachs (2012) and Diamond (2012c).

14 Although not explicitly discussed in this book, fiscal transparency—defined as the clarity, reliability, frequency, timeliness, and relevance of public fiscal reporting and the openness to the public of the government’s fiscal policymaking process—is a critical element of and permeates effective modern fiscal management.

STRUCTURE OF THE BOOK

This book is divided into four parts. Its organizing principle is described by Schick in Part I, An Overview of Contemporary Public Financial Management Reforms. He draws a distinction between the different categories of innovations. The first category is major innovations that have introduced new or reinvigorated ideas and initiatives into PFM and that focus on specific issues such as the management of fiscal risks. The second category comprises reforms to the basic supporting PFM infrastructure, for example, accounting and budgeting frameworks. Modernizing this supporting infrastructure is important for providing the information and capacity to successfully implement the major innovations. This is echoing to some extent a back-to-basics theme often heard in many debates on PFM reforms in advanced as well as in developing contexts.

Accordingly, and following the architectural theme of this book, Part II discusses Designing and Building: PFM Innovations and Reforms. Part III focuses on Strengthening the Foundations: Modernizing the PFM Infrastructure. Part IV, Adapting to the Environment: PFM Reform in Developing Countries, brings to the fore selected aspects relevant particularly, but not exclusively, to designing PFM reforms in developing countries.

Part I. An Overview of Contemporary Public Financial Management Reforms

In the overview chapter, “Reflections on Two Decades of Public Financial Management Reforms,” Schick promotes a better understanding of how PFM innovations operate, how they interact with each other, and how they can be integrated into a comprehensive PFM structure. This chapter provides an original framework relating innovations to the three key PFM objectives and to three common levers or instruments—new information, process adjustments, and restrictive rules—used by reformers to achieve their objectives. The first two levers operate through changing the incentives and the behavior of politicians and public servants and the third by imposing restrictions on actions and decisions.

The chapter uses this framework as a lens through which to assess the major innovations and supporting reforms that are discussed in detail in Parts II and III. New information is essential for nearly all major innovations. Information on fiscal risks, evaluations of programs, and projections of debt and deficits can provide politicians and managers with new perspectives and motivate them to change existing policies. Schick argues, however, that in most cases information alone is not sufficient to influence behavior.

Politicians and managers are less likely to disregard new procedures than new information. The main issue is whether the new procedures will change behavior or become just another task that managers must complete. For example, a procedural requirement to include performance information in budgeting and
management processes can be used by managers to improve results or it can be seen as another technical requirement with little impact on decision making.

When the first two levers do not work, preferred procedures may be codified into rules, such as fiscal limits on debt or deficit, that constrain government actions. Rules have several advantages, the most obvious being that they cannot be disregarded as easily as new information and permissive procedures. Nevertheless, to work, rules have to build on innovations in information and process and not be a substitute for them.

Schick stresses that a government should apply constrictive rules only when it has a good understanding of why enhanced information and processes do not work. He cautions that not every procedure should become a constraining rule because it may end up limiting the discretion of democratically elected leaders, introducing rigidity into the PFM system, and becoming an end in itself rather than a means to an end.

The chapter concludes the discussion on levers by acknowledging that there is no “automatic transmission belt” that converts levers into modified behavior and changed behavior into substantive outcomes. PFM is an open system exposed to many economic and political factors that affect incentives and behavior of politicians and public servants. Therefore, this chapter and this book stress the importance of a country’s underlying political and administrative culture and institutions and the role of political and managerial leadership in successfully implementing reforms.

As the 2008–09 crisis emanated from the financial sector, PFM has largely been a bystander since the onset of the crisis and during its initial stages. The real test for PFM was in the precrisis years in which, Schick argues, some innovations did not yield the expected results. Under unfavorable economic conditions, spending was increased to stimulate the economy, but when conditions were more favorable, spending was not lowered. In sum, in good times governments did not save. The average gross public debt-to-GDP ratio for the Group of Seven nations rose from 35 percent in 1974 to more than 80 percent in 2007, just before the crisis (Cottarelli and Schaechter, 2010). Schick concludes that PFM can make a difference to fiscal and budgetary outcomes, and the still-emerging lessons from the crisis about PFM innovations can improve them and contribute in the future to averting or at least better managing the next crisis. Key among the lessons is the need to redesign fiscal rules and improve fiscal risk management to look beyond the government sector.

Part II. Designing and Building: PFM Innovations and Reforms

Chapters 2 through 6 examine different innovations—fiscal responsibility legislation, numerical rules, MTBFs, fiscal risk management, and independent fiscal agencies—that concentrate on promoting fiscal responsibility. Although the objective is the same, different levers and approaches are used. Chapters 2 and 3 focus on codifying procedures and rules. MTBFs, discussed in Chapter 4, seek to
contribute not only to fiscal sustainability, but also to the two other PFM objectives of effective allocation of resources and efficient delivery of services, and can use all three levers—new information, changing procedures, and rules—to influence behavior. Chapters 5 and 6 emphasize fiscal sustainability and the role and importance of information and analysis. Performance budgeting and information, covered in Chapter 7, are expected to contribute to the goals of effective allocation of resources and efficient service delivery. Performance budgeting relies on new information and changes in procedures to improve performance.

Van Eden, Khemani, and Emery explore in Chapter 2 how fiscal responsibility laws (FRLs) can support more sustainable and transparent fiscal policies. Since the 1990s, there has been a significant growth in the number of countries that have developed fiscal responsibility provisions, which embed in law an agreed-on set of arrangements intended to promote fiscal discipline, transparency, and accountability. This chapter argues that design choices are critical to the success of FRLs and explores different design options. In designing FRLs it is important to start with modest and flexible frameworks then gradually move to more prescriptive legal requirements for fiscal policy. Building up PFM capacity is an additional reason to take a gradual approach. The more complex the law, the greater the capacity needed. This chapter concludes that FRLs, in conjunction with the other innovations discussed in this section (MTBFs, a new generation of numerical fiscal rules, and independent fiscal councils), can play an important role in strengthening fiscal outcomes. When adopting these laws, however, reformers should not stride too far ahead of societal acceptance and recognition of the importance of fiscal sustainability.

In Chapter 3, Budina, Kinda, Schaechter, and Weber take stock of the development and use of numerical fiscal rules—long-lasting constraints on fiscal policy through the application of numerical limits on budgetary aggregates. This chapter provides a systematic compilation and comparison of numerical fiscal rules and their design elements. In particular, it reviews trends—from the mid-1980s through early 2012—in the types and number of rules, as well as their combinations and main characteristics. This review includes discussions of the legal bases, enforcement, coverage, escape clauses, and provisions for cyclical adjustments. The chapter also examines the next generation of fiscal rules emerging in the aftermath of the 2008–09 global economic and financial crisis. To be effective, it is important that rules be an integral part of the budget formulation and execution cycle and have the necessary supporting institutions. Despite widespread application, fiscal rules are not without challenges, including relative rigidity in adjusting to shocks and the potential to generate incentives for creative accounting. The next-generation fiscal rules, which are attempting to address some of these issues, tend to be more complex, thus creating new challenges in design, implementation, and monitoring. Given their relatively high degree of complexity, their effectiveness will also depend on country-specific institutional capacity.

A key issue in PFM is the inability of government to look beyond a one-year time horizon when making decisions on current or proposed policies and
expenditures that have fiscal implications for many years ahead. To help address this concern, over the last two decades more and more countries have developed MTBFs. Harris, Hughes, Ljungman, and Sateriale in Chapter 4 define MTBFs as “a set of institutional arrangements for prioritizing, presenting, and managing revenue and expenditure in a multiyear perspective.” There is no single MTBF model. Countries have taken a range of approaches. Preconditions for a successful MTBF include a credible and predictable annual budget, accurate medium-term macroeconomic and demographic projections, established fiscal objectives and rules, and a comprehensive top-down budget process. This chapter stresses the importance of design for success. Using original empirical research, it tests the impact of the different types of MTBF on fiscal outcomes and allocative efficiency. It also examines how selected MTBFs have been adjusted to help governments respond to, and deliver, both fiscal stimulus packages and fiscal consolidation.

The global financial crisis dramatically illustrated the importance of managing the fiscal risks to which public finances can be exposed. Budina and Petrie in Chapter 5 assess the trends since the early 1990s toward more active disclosure and management of fiscal risks. They explore in detail how a fiscal risk management cycle tool can help governments identify, analyze, and incorporate risks into the budget, and disclose, mitigate, and monitor those risks. Since 2000 some progress has been made on disclosure of information on fiscal risks, and a few countries have developed fiscal risk statements. The IMF guidelines for fiscal risk management provide countries with risk disclosure and management principles. Although some countries have made advances, risk management for many others remains at a basic level. As the crisis illustrates, many challenges in improving risk management remain. Key among them is the lack of a systematic and centralized approach to identifying risk; simply put, many governments have no basic information on the range and magnitude of risks to which they could be exposed. The chapter concludes that in the wake of the crisis, the ability to identify and analyze risks has become more critical than ever. The priorities and capacities for strengthening risk management, however, will depend on individual country circumstances and conditions.

Another trend emerging since the crisis is an increased emphasis on independent scrutiny and analysis of governments’ fiscal policies, plans, and performance and the corresponding growth in independent fiscal agencies. Among these, fiscal councils are hailed as a mechanism for promoting fiscal responsibility. Hemming and Joyce, in Chapter 6, review the justification for establishing independent institutions and councils, the different roles and functions they perform, and the requirements for their success. Councils do not exercise influence through formal procedures or rules but by providing independent information and analysis that can influence policymakers and the public. The theory is that independent review improves fiscal transparency, which can, in turn, enhance fiscal discipline. Fiscal councils can be advisory bodies reviewing and commenting on government fiscal policies, and/or auditing bodies that verify the reliability of government information, including the quality of their forecasts. This chapter presents a number of
factors influencing the success of a fiscal council, including guaranteed independence, formal influence, political support, clear legal backing, and technically qualified staff. It concludes that although, in principle, fiscal councils can play a role in promoting fiscal discipline, it is too early to disentangle their impact on fiscal outcomes.

Curristine and Flynn in Chapter 7 examine governments’ continuous quest for improved public service efficiency and performance. Performance tools—performance management, measurement, and budgeting—have become an integral part of how governments do business. These tools all depend on performance information (PI) to measure, monitor, and improve performance. Nearly all OECD countries have developed PI and many have introduced procedures to integrate it into accountability, budgeting, and management processes. The issue is getting this information used in decision making. Information is not an end in itself but a means to better performance. In many countries it has proven more challenging to ensure the use of PI in budgeting than in management. This challenge arises from problems in aligning incentive structures, political economy issues, and informational and institutional constraints. This chapter also discusses how PI can be used in fiscal stimulus and consolidation, arguing that the approach to its use will depend on many factors, including speed and depth of consolidation, existing performance budgeting systems, the quality of PI, and the political willingness to use it. The chapter concludes by highlighting selected countries’ experiences with spending reviews.

Part III. Strengthening the Foundations: Modernizing the PFM Infrastructure

Part III builds on one of Schick’s themes—the critical role of information—by focusing on developments that have taken place in public accounting and reporting, cash and debt management, and public investment. It also sheds some light on accrual-based budgeting, a reform that only a limited number of countries have attempted. All the reforms discussed in this part contribute to all three PFM objectives. They are important for supporting the innovations discussed in Part II; for example, improving fiscal reporting supports better management of fiscal risks and enhanced transparency.

Blondy, Cooper, Irwin, Kauffmann, and Khan in Chapter 8 examine the trends in fiscal reporting over the past decade. Government reporting on its fiscal position, whether in financial statements, fiscal statistics, or other documents, is vital to PFM and contributes to its three objectives. This information is essential for governmental decision making and for accountability. Significant changes have occurred in this area in the past decade. The comprehensiveness of reports has improved because many governments that in the past reported only cash flows and debt now report assets and liabilities. The adoption of accrual-based reporting has been motivated by the realization that cash reporting does not reveal costs in a timely manner, which in turn spurred the development of new accrual-based international statistical and accounting standards. Another important development is
the extension of coverage of reports beyond just the central government, to include local governments and more public entities in an effort to limit off-budget spending. Despite these developments, reporting before the crisis gave few warnings of the looming problems; the risk posed by the financial sector was largely ignored in fiscal reporting and statements. The crisis emphasized both the importance of fiscal reporting and the need for further improvements, including increased focus on government balance sheets.

Gardner and Olden in Chapter 9 discuss how governments’ management of their financial assets and liabilities has evolved since 1990. The chapter focuses on changes in how governments have managed their cash and debts during this period. Significant changes have been driven by the increased volume and complexity of financial markets, by innovations in information and communication technologies, and by new institutional designs and capacity building. There is also a greater awareness of the need to integrate the management of all government financial assets and liabilities. Increasingly, debt management offices have been given responsibility for cash management. This chapter argues for an integrated as opposed to fragmented approach to cash and debt management for a variety of reasons. Integrated management creates incentives to manage all government financial resources in a portfolio, avoids sending confused signals to the markets, and consolidates scarce resources by allowing streamlining of information technology systems and back-office facilities. In addition to discussing recent trends, this chapter examines current challenges and specific issues facing emerging and developing economies. It also addresses how countries that had already developed effective systems before the crisis have benefited from them during the course of the crisis.

Fainboim, Last, and Tandberg in Chapter 10 examine the changes in public investment management during the past 20 years. Even before this period, the management of public investment had undergone noteworthy changes. Against a global decline in public investment, the authors observe the abandonment of national plans and planning ministries in advanced economies in favor of decentralizing this function to sector ministries and the elimination of dual budgeting. The chapter considers how some of the PFM innovations discussed in Part II of this book, including MTBFs and performance budgeting systems, have affected the way that governments manage their public investments. Despite the mainstreaming of public investment into government management and budgeting, its unique nature still requires some specialized tools. This chapter discusses selected new and revamped public investment management tools. It also addresses changing approaches to financing public investment, concentrating on public-private partnerships and highlighting the importance of understanding and managing the risks created by these contracts. Public investment management and planning has significantly benefited from PFM innovations. However, despite these benefits, procyclicality and the stop-and-go nature of public investment persist, as made evident during the crisis.

Khan in Chapter 11 discusses accrual budgeting. Although many governments have introduced accrual accounting, only a few have adopted accrual
budgeting. These are countries that already produce ex post financial reports for central government on an accrual basis. No single model of accrual budgeting exists. Countries have adopted different frameworks suitable to their country contexts. This chapter examines why accrual budgeting can be a useful reform and how it works in practice, and notes the different country approaches. This chapter considers the potential benefits and challenges of accrual budgeting, along with the prerequisites for successful implementation. Among these prerequisites are a phased approach to implementation, political support, a sound cash budgeting system, and technical capacity.

**Part IV. Adapting to the Environment: PFM Reform in Developing Countries**

Although much of the focus of this book is on advanced economies, this part explores issues and challenges in implementing PFM reforms in developing countries. It stresses the importance of adapting PFM innovations to the environment and individual countries’ contexts and capacities. Each of these chapters discusses the sequencing of reforms, the impact of context and differing institutional and technical capacities, and the influence of political economy factors on PFM reform prospects in developing countries. These considerations also apply to advanced and emerging economies.

Fedelino and Smoke in Chapter 12 examine an underresearched topic: the links between PFM and decentralization reforms. Conceptually, the link between these reforms is strong and mutually beneficial. In practice, however, this link is rarely established. Decentralization reforms and PFM reforms are often formulated as independent initiatives managed by different agencies with different goals—thus, uncoordinated and not sequenced. This lack of synchrony creates inconsistencies in government systems and operations and sends mixed signals to key actors. This chapter argues for more integrated analysis and better coordination in the development and execution of PFM and decentralization reforms. It emphasizes the importance of more systematic and formal analysis to help reformers understand the implications of country context for the links between PFM and decentralization.

In Chapter 13, Dabán and Hélis explore how well-designed and sequenced PFM reforms can help natural resource–rich countries manage their public finances and avoid the resource curse. This chapter asserts that weak institutions in the preresource period, combined with poorly designed, opaque, and rigid resource-specific operational mechanisms, have contributed to the curse in some countries. The few countries that have successfully avoided the curse already had strong institutional and PFM systems in the preresource era. Resource-specific mechanisms, when poorly designed, can reduce the efficiency of government spending and result in fragmentation and delay in the budget process. By explaining the unique challenges of managing finances in natural resource-rich countries, this chapter develops a PFM framework and sequenced reform path for these countries, seeking to enhance rather than replace or
bypass existing budgetary institutions so as to preserve the integrity of the budget process.

Finally, Allen in Chapter 14 presents an analytical perspective on the current debate about the challenges of reforming budgetary institutions in developing countries. The chapter explores the factors that determine the development of budgetary reforms and what can be learned from advanced economies about prioritizing and sequencing reforms. Advanced-economy experience shows that reforming budget institutions is a very slow and challenging process, closely related to wider societal, political, and economic institutional developments. Further complications are that reforms require a willingness on the part of politicians to make hard choices; incentives for reform among politicians and public servants are weak; ministries of finance tend to be weak; and fragmented budgets are a common problem. This chapter asserts that transplanting advanced-economy approaches to reforming budget institutions into the alien environment of developing countries is likely to be unsuccessful. Although there are some exceptions, they are rare. The chapter argues that the more successful improvement strategies have a relatively short time horizon, focus on narrow and specific objectives, and involve a large element of trial and error.

WHERE DO WE GO FROM HERE?

In line with the leading theme of this book—the emerging architecture of PFM reform—this section refrains from providing any firm conclusions. The hope of this book is instead to distill a number of considerations for decision makers, international public finance specialists and practitioners, and the public at large.

- Modern PFM comprises a set of increasingly complex processes, rules, systems, and norms that are intrinsically linked to one another. Heated discussions on individual innovations often ignore this simple tenet and confuse the trees with the forest. Every reform needs a champion but very few champions have the vision to see how each innovation is interconnected with others and how only a harmonious assembly of all the bits and pieces has the chance to ultimately provide the answers and solutions sought.

- The relative emphasis on PFM’s three key objectives—maintaining a sustainable fiscal position, effective allocation of resources, and efficient delivery of public goods and services—has shifted from the effectiveness and efficiency arguments to fiscal sustainability. Once again, these three objectives should not be addressed in isolation. For a long time, however, the sustainability aspect was neglected, with the obvious result that a string of “good years” was wasted with no strengthening of fiscal positions while precious time and resources were invested in other—and with the annoying benefit of hindsight, arguably less important—aspects of PFM.
• The importance of the particular context—historical, political, and geographical, but also human capital—in which a country decides to manage its public finances better cannot be stressed strongly enough. There are no magic bullets or cookie-cutter approaches to strengthening PFM, and any attempt to import innovations that may have worked elsewhere should be carefully assessed and subjected to an “on-the-ground” reality check. The same applies to political economy considerations and reforms aimed at addressing more systemic public administration or governance aspects.

• The importance of information also cannot be overly stressed. In still too many instances, countries have been caught by surprise because the coverage—either of institutions or of transactions—of fiscal activities was not fully captured. The focus is not only on past and current fiscal developments, but even more forcefully on future developments. The progress made on reporting standards is part of the effort to define better ways to convey an accurate picture of public finances for various purposes, from aggregate demand management to accountability.

• Related to the point above is the current emphasis on extending the horizon of fiscal policy by adopting medium- to long-term frameworks aimed at making clear the impact of today’s policy decisions on tomorrow’s outcomes. A better appreciation of fiscal risks—in a nutshell, all factors that can explain outcomes different from planned—has now been widely accepted, although the practice is still lagging.

• Information can also be a double-edged sword. Although it has to fulfill many purposes, including international comparability, actors are always tempted to make information an end in itself instead of a means to help policymakers design and implement the best responses to society’s needs. Numerous examples of information overload have proved frustrating to those involved in its production and those incapable of making good use of it. Information alone may in many cases not be sufficient to change key actors’ behavior.

• A plethora of discussions, theories, and approaches to the sequencing of PFM reforms have arisen since the mid-1990s. We may have come full circle with the obvious conclusion that “it depends on a number of country-specific factors.”16 “Basic first” seems to be the prevailing view at this stage, but it should not lead to oversimplification and a too-rigid approach; individual countries may occasionally leapfrog and make the most of available technologies and lessons from early reformers. External factors, most notably political economy aspects but also human capital, can help explain why reforms tend to take longer than initially planned and in many instances turn out not to be sustained over time, causing undesirable backsliding.

Viewing PFM as an integrated framework and taking account of the considerations discussed above are essential in the wake of financial and economic crisis and, possibly, in trying to prevent the next one. As is often the case, however, it may be necessary but not sufficient. Bringing about a paradigm shift whereby responsible and accountable policymakers make decisions taking account of long-term considerations and the implications for the entire public sector on the basis of the best available ex ante and ex post information may require more than full implementation of the innovations discussed in this book. We should not forget, however, that many of them remain to be adopted or fully absorbed by most countries. This is therefore the agenda for the immediate future. Nevertheless, if the past provides any lessons, other innovations will come along to strengthen PFM’s emerging architecture.

Finally, does this book provide an architectural design for modern PFM? We hope so. As noted at the outset, the objective is to identify PFM’s constituent elements, along with a number of considerations that should be taken into account in designing the PFM framework most suited to addressing the needs of a particular society. Going beyond that would be pretending to have discovered a magic formula that does not and cannot exist. In assembling some of the innovations discussed in this book, the ultimate design will have to take into account individual countries’ specific contexts and the need for flexibility to adapt to sudden changes in circumstances. Architects and engineers have learned over the years to design buildings that can withstand earthquakes, so future PFM frameworks will be well equipped to manage public resources when facing increasingly strong tremors. We are getting there; we are just not there yet.

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Cangiano, Curristine, and Lazare


Adapting to the Environment: PFM Reform in Developing Countries
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Decentralization—the allocation and sharing of the responsibilities for managing public functions and resources across levels of government—has been a pervasive international trend since the early 1990s. This chapter explores the links between reforms to public financial management (PFM) and those to decentralization. Conceptually, a strong and potentially beneficial relationship exists between these two initiatives. In reality, in many countries, coordination and sequencing of decentralization and PFM reforms has proved to be elusive. This chapter examines how more integrated analysis and better coordination in the development and execution of PFM and decentralization reforms could potentially yield benefits for overall public sector performance.

PFM reforms are vital to attaining the expected benefits of decentralization because of their critical role in maintaining fiscal discipline, efficient provision of public services, and accountability of subnational governments to higher levels of government and local constituents. At the same time, subnational governments can be critical actors in the effective implementation of PFM reforms in countries where they have been fiscally empowered through decentralization reforms. Correctly balancing central control and local autonomy is important. PFM reform that is too lax creates the risk of enabling irresponsible local government fiscal behavior, whereas PFM reform that is excessively controlling can unduly constrain the local autonomy essential for effective decentralized systems.

The relationship between these reforms, however apparent in principle, is not well established in practice. The two reforms are often formulated through independent initiatives and managed by different national agencies with somewhat contradictory perspectives and objectives. In developing countries, the two reforms are typically supported by different international organizations with similarly conflicting priorities. Conflict between those responsible for PFM reform and those responsible for decentralization policy is not uncommon, and the two efforts may also start at different times. The resulting reforms can create mixed signals for actors and generate inconsistencies in government systems and operations. These types of conflicts occur in virtually all countries undertaking PFM and
decentralization reforms, but are ubiquitous in developing countries where policy and management coordination failures are particularly risky and institutional capacity is often spread too thin, chasing too many and sometimes incompatible reform initiatives. These countries are thus the primary focus of this chapter.

This chapter neither advocates nor discourages decentralization but instead takes the position that different types and degrees of decentralization are appropriate in different circumstances. In addition, it recognizes that once decentralization is undertaken, often for political reasons, backtracking to any substantial degree is difficult. One critical role of PFM reform is to help ensure that subnational governments conscientiously execute their new responsibilities as they evolve under decentralization, but how exactly this happens will differ from case to case. The analysis highlights that more robust contextual assessment than is normally undertaken can help analysts understand the implications of country context for links between decentralization and PFM.

Throughout, this chapter emphasizes the need to take political economy factors into account in developing and linking the two types of reform. Both PFM and decentralization have important technical dimensions. The design and implementation of these potentially complex and far-reaching reforms, however, is not a purely technical exercise, and treating them as such can lead to infeasible or problem-ridden reform programs that may even hinder the attainment of the results they seek to promote. Similarly, treating these reforms as purely political measures without sound commensurate technical underpinnings may also doom them to fail.

This chapter is organized as follows: The first section discusses the array of challenges to aligning PFM and decentralization reforms in practice and considers how context may influence starting points for PFM and decentralization and also affect the relationship between national and subnational PFM systems. The second section covers selected case studies that illustrate the diverse links between PFM and decentralization reform and how they play out in the reform process, and considers how they might be developed better to improve results in the future. The final section draws some preliminary general lessons from the case studies and other available information about how to more robustly analyze and effectively bridge PFM and fiscal decentralization reforms.

12.1. CHALLENGES TO BRIDGING PFM AND FISCAL DECENTRALIZATION

Trying to ensure that PFM and decentralization reforms are coordinated and not independently developed, as is typically the case, can yield potential benefits. Making this coordination happen, however, is not straightforward, even in the

1The literature analyzing the benefits and pitfalls of decentralization is well known, but its results are relatively weak and inconsistent. Ahmad and Tanzi (2002), Ahmad and Brosio (2006), Smoke (2006), Shah (2008), and Fedelino and Ter-Minassian (2010) provide literature reviews of conceptual and empirical arguments in favor of and against both fiscal and general decentralization.
best of circumstances. A number of factors complicate the coordination of PFM and decentralization reforms, including

- differences in the nature and objectives of the two reforms;
- contrasting institutional frameworks for developing reforms, and variations in the form of the intergovernmental system;
- diversity of starting points for reform;
- prioritizing, timing, and sequencing of reform processes as driven by political, technical, and other considerations;
- commonly excessive focus on normatively sound design of reforms relative to pragmatic implementation; and
- the role of international development and financial institutions, particularly in aid-dependent countries.

Each of these factors is explored in more detail below.

12.1.1. Differences in Nature and Objectives of PFM and Fiscal Decentralization Reforms

The commonly weak links between PFM and decentralization reform are not difficult to understand. First, the two reforms differ somewhat in their nature. The key elements of PFM are similar for all governments and concentrate on the management of public finances and the budget process (budget preparation, approval, and execution). PFM reforms are generally concentrated on financial management issues and are more technical and uniform than decentralization initiatives. Moreover, PFM reforms are, in many cases, adjusted to specific country contexts.

In contrast, decentralization involves a greater variety of diverse reforms related not only to fiscal, but also to political (subnational elections and accountability) and administrative (territorial, organizational, and nonfinancial procedural) concerns. Fiscal decentralization cannot be meaningfully divorced from these other dimensions because it cannot work effectively without them. In addition, these elements may collectively play out in highly diverse ways in different contexts, with varying degrees of functional empowerment, fiscal self-sufficiency, and autonomy across levels of government.²

For example, under decentralization more spending autonomy is often granted to subnational governments to improve service delivery. Fiscal federalism theory suggests that this initiative should result in improved (optimal) resource allocation if appropriate functions are decentralized. But without the mechanisms and conditions that create incentives for local administrators and politicians to perform (e.g., if local administrators are not following sound managerial practices, if local politicians are centrally appointed rather than elected, if local political

²Eaton and Schroeder (2010) provide a useful review of the literature on measuring and linking the various aspects of decentralization.
competition is limited), the lack of appropriate managerial practices and accountability to users of public services will hinder efficiency improvements. A change in intergovernmental fiscal relations (in this case, spending autonomy) will not be meaningful unless it is appropriately linked to broader institutional and political contexts. Clearly, the nature of the intergovernmental system and the relative importance of various levels of government make obvious the need for different approaches to decentralization and for different types of related PFM and other systems and procedures.

Second, the objectives pursued through PFM and decentralization reforms may vary considerably in different circumstances. Although there are country variations and PFM reforms with diverse goals, ultimately PFM reforms tend to focus on achieving one or more of the core PFM objectives of maintaining a sustainable fiscal position, effective allocation of resources, and efficient provision of public services (see Chapter 1). Decentralization is often formally justified as a means to improve the performance of the public sector in meeting citizen needs, but the range of actual objectives is very broad, including improving democratic governance and promoting peace. Furthermore, particular objectives can have varying degrees of importance in different cases, requiring substantially different types of reform.

In some countries, decentralization is initially more focused on promoting democratic governance than on enhancing service delivery and fiscal accountability. For example, after decades of dictatorship and neglect of the poorest regions, Bolivia embraced decentralization in the late 1980s to strengthen democratic structures. Municipal elections were first held in 1987 (changes to regional governments came nearly two decades later). In postconflict or in-conflict countries, the primary objective of decentralization may be to maintain or promote peace and to develop greater political stability, as demonstrated by the experiences of Cambodia, the Democratic Republic of the Congo, Iraq, and Kosovo. Depending on governments’ prioritization of the multiple objectives of decentralization, they may feel the need to pursue dramatically different sequences, trajectories, and paces of reform.

Third, a committed government may find it somewhat easier to start fresh with extensive PFM reforms than with an entirely new intergovernmental system. The obstacles to introducing PFM reforms may be lower partly because they are typically less political and visible to the public and thus attract less public debate and support or resistance than do decentralization reforms.

3 Allocative efficiency can be undermined by devolution, however, if preferences are homogeneous (subnational governments have no informational advantage over the center), economies of scale are present (services cannot be provided efficiently by smaller jurisdictions), or externalities exist (subnationals do not take into account the effects of their decisions on other jurisdictions). Concerns have also been raised about subnational jurisdictions engaging in detrimental competition to attract mobile labor and capital (the “race to the bottom” via a reduction of taxes, among others) and about the risk of local elite capture and corruption once central oversight is removed. Conceptual thinking and empirical evidence on these latter issues, however, is far from conclusive. For more analysis of these points, see United Cities and Local Governments (2008, 2010).
12.1.2. Differences in Institutional Frameworks and Perspectives

Generally, different actors are involved in the design and implementation of the two types of reform. The institutional framework surrounding decentralization reform is usually more complex than that for PFM. PFM reform is normally (although not always and not exclusively) managed by the ministry of finance or national treasury. These agencies often have considerable authority over other state institutions by virtue of their control over national budgeting and financial management. Decentralization reforms are more typically, although again not always, managed by other agencies, such as the ministry of local government (e.g., Kosovo and Uganda), the ministry of interior (e.g., Cambodia), or the ministry of home affairs (e.g., Indonesia).

These national agencies responsible for local government oversight are commonly at odds with the ministry of finance, either because they are more pro-decentralization or because they are trying to take over some local government oversight functions that the ministry of finance may feel are under its jurisdiction. In addition, local government ministries rarely operate from a position of relative strength in the overall political and administrative landscape. They must rely on developing good working relationships with central agencies that define government-wide policies, such as the ministry of finance, civil service commission, and ministry of planning. They must also cooperate with those spending ministries and agencies that oversee and support delivery of public services, such as the ministry of education, the ministry of health, and the ministry of public works. Thus, for decentralization to work effectively, a broad range of actors with different perspectives and levels of influence must be accommodated. Effective coordination is critical but usually difficult to achieve owing to inherent and evolving tensions between the underlying roles and objectives of these actors.

Decentralization also involves the adoption of new systems and procedures, but it is rare for a national government to pursue aggressive comprehensive reform. Few governments, for example, seek a complete restructuring of territorial jurisdictions, even though there may be good fiscal, political, or administrative reasons to do so. Existing jurisdictions may be too small to be fiscally viable and to allow for economies of scale or the internalization of externalities in service delivery, or they may be too large to be well connected to citizens politically. However, the boundary changes needed to correct such problems are often strongly resisted. Thus, some institutional parameters that could improve the quality and impact of decentralization (and related PFM reform) may be difficult to modify substantially, at least initially.

12.1.3. Diversity of Context and Starting Points

Understanding the context in which PFM and decentralization reforms will be initiated is important for their design and implementation. In some cases in which reforms are being considered, a credible PFM system might already be in place, but is not being used properly. In other cases, some elements of a quality
PFM system may be in place, but others need to be developed. In still other cases, the current PFM system may be dysfunctional, nontransparent, and politically captured, and reformers face the challenge of building an entirely new system.

Decentralization may take various forms, including deconcentration, in which subnational administrative entities report primarily to higher levels of government; delegation, in which subnational entities are contracted to perform specific functions; and devolution, in which subnational administrative entities report primarily to locally elected councils. The latter type of reform has been the preferred practice in recent years, but many countries have or aspire to a mixed system that blends these various approaches, and different levels (intermediate versus local) can be given different roles.

In some cases, higher or intermediate subnational levels (states or provinces) have greater functions or more autonomy, such as in Ethiopia, India, and Vietnam. In other cases, lower levels (such as municipalities and districts) play a greater role or enjoy more autonomy than higher levels, as in Indonesia, Kenya (pre-2010 constitution), and South Africa. Sometimes such divisions of responsibility are primarily based on political consideration (e.g., empowering local levels to diffuse ethnic tensions associated with regional levels), but specific functional assignments are normally justified by the nature of specific services. Some services, such as garbage collection, street cleaning, and traffic and parking are naturally local, and the central government can relinquish control over them with little political or economic risk. Other services that have broader effects would be assigned to a higher level of government or shared among levels of government, and the center would likely retain some control over them.

In any of these cases, subnational administrative or government units may be at various stages of PFM development, and depending on the nature of the system, may have different relationships with national PFM systems. Normally, for example, deconcentrated levels are fully integrated into the national budget, whereas devolved levels are usually characterized by independent budgetary systems and norms.

Decentralization can also start from very different positions. In some cases, the term is used to refer to the reinventing or strengthening of subnational governments that already exist but have not been functioning well. Thus, reforms may target the improvement or replacement of existing systems and procedures, and may take place over varying periods of time and through different mechanisms. The Kenya Local Government Reform Program that began in the mid-1990s, for example, was intended to improve the performance of long-standing local governments by instituting new procedures and incentives and using innovative strategic reforms and learning-by-doing training. The 1991 constitution of the former Yugoslav Republic of Macedonia, following independence from the Socialist Federal Republic of Yugoslavia, defined existing municipalities as the basic unit of local government. The center, however, continued to dominate

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This initiative is documented in Smoke (2003, 2008a, 2008b). The situation in Kenya changed with the adoption of a new constitution in 2010 that mandates substantial devolution.
public finances, and municipal elections were not held until 2005 as part of a new, multiethnic democratic order adopted in response to the ethnic Albanians’ armed rebellion.

In other cases, decentralization means transforming existing local administrative units of the central government (deconcentrated system) into elected levels of more autonomous subnational governments, as occurred in Indonesia. Reforms thus attempt to realign accountability structures (usually changing the balance from primarily upward to a greater focus on horizontal and downward) with reformed or new systems and procedures supported by capacity building.

In extreme cases (usually postconflict or low-income countries), decentralization can involve the creation of subnational administrations or governments. In situations in which units of government are newly created or revamped, decisions must be made about which levels to create or empower, the nature of their relationships with other levels, and how to build appropriate new systems and procedures, including PFM systems, over time. This is the process under way in Cambodia as the country expands the decentralization reforms, initially limited to the commune level, to the district and provincial levels.

12.1.4. Reform Priorities and Sequencing

Another major concern in considering the relationship between PFM and decentralization reforms is the relative primacy of each from the perspective of the national government and external entities supporting reform programs. On the one hand, PFM is often seen as a building block or a precondition for fiscal decentralization, the contention being that PFM reform should lead fiscal decentralization reform. The argument is that as new (or expanded) responsibilities for managing public functions and resources are assigned and shared among various levels under decentralization reform, a sound PFM system ensures that these functions and resources can be properly managed and monitored—thus contributing to the success and sustainability of decentralization itself.

This approach, however, is more likely to be more feasible in countries where an orderly program of public sector reforms is being rolled out by a reform-minded government. But where decentralization was initially undertaken for broader and, from the government’s perspective, more urgent, often political, objectives, it may not be feasible to postpone subnational reforms until sound PFM reforms and systems are substantially developed. Where some key decentralization parameters are already in place when PFM reform begins, the PFM agenda would ideally at least partially respond to the decentralization agenda rather than the adaptation being fully reversed.

Examples of such situations include countries in which subnational elections have been held as the result of perceived political urgency during a period of crisis or a major political turnover or in an immediate postconflict environment. Under such circumstances, it may be counterproductive for the new representative entities to be idle with no functional assignments, unable to show any results to the constituents who elected them, while state-of-the-art PFM reforms are
being fully worked out and implemented. This was the experience in the newly created (Serbian-majority) municipalities in Kosovo. Following municipal elections in late 2009, new administrative structures were quickly established, but they were initially institutional shells preparing for the exercise of new functions, and the elements of the system, including PFM, to be phased in.

Although subnational governments should not be excessively empowered before basic PFM reforms are in place, they must perform some visible functions to validate their existence and begin to develop credibility with citizens, especially if the overall public sector is perceived to lack legitimacy. In such cases, PFM and decentralization reforms need to be built simultaneously rather than sequentially; PFM reforms are sometimes part of decentralization reforms even before an overarching PFM reform program begins.

In low-capacity, aid-dependent countries, decentralization may start as an externally funded parallel system intended to provide limited local services and to develop local governance ahead of formal decentralization or major PFM reforms. Such developments cannot be ignored when PFM reforms are being designed. In some cases, these parallel systems create better PFM processes at the subnational level than those being used by the central government. To automatically assume that they must be replaced by a normatively defined, comprehensive national approach could be counterproductive.

Cambodia’s decentralization, for example, first emerged from an initially small donor-funded project that evolved into the creation of a modest local government (commune) system. Local PFM procedures were piloted and revised as part of an integrated overall system, and they generally improved and reflected higher standards of reporting and monitoring than those of the central government’s deficient PFM system. Although a major national PFM reform was later initiated, many of the old problems remain, and it is unclear which of these practices—commune, old national PFM, under-reform national PFM—will prevail subnationally as the central government empowers local governments above the commune level and the ongoing national PFM reforms are rolled out.

More generally, even if the subnational systems are less well conceived than best practices would require, PFM reformers may run the risk of creating more problems than they solve if they try to impose new normatively ideal reforms rapidly on nascent subnational systems. Thus, careful analysis and a strategic approach to reform are required.

12.1.5. Beyond Reform Design to Strategic Implementation

As noted above, best practice design has been a major thrust of public sector reform, especially when supported by international agencies. Inflexibly using demanding normative reform principles in developing countries often results in the proposal of systems that are far more advanced than what is in place in the country and will require massive changes to attain. The common approach of

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Smoke and Morrison (2011) review the Cambodia experience and the relevant literature.
building capacity by offering intensive training courses is rarely sufficient to build appropriate skills and modify the behavior of relevant actors. In addition, even when such systems are formally adopted, they may be partly neutralized by the continuation of business as usual by powerful actors.6

Given commonly experienced delays and diversions in bringing many well-designed reforms to life, more attention has been paid in recent years to implementation strategy.7 The use of the platform approach to PFM reform is an example. This approach is discussed elsewhere (Chapters 1 and 14), so this subsection focuses on decentralization implementation.

Emphasizing implementation in no way minimizes the importance of using normative principles to envision and design the eventual intergovernmental system. It simply advocates framing the implementation of the desired system in the context of a well-considered process. So, for example, a key decentralization concern, such as obtaining an appropriate balance between legitimate national priorities and a degree of subnational autonomy that meets the basic requirements of decentralization, need not have a single, one-time resolution. Reformers may intend to allow significant subnational autonomy eventually, but in the early stages of reform, when subnational accountability and capacity are low, greater national control would be warranted. The issue, then, is how to prevent the system from stagnating in a centralized form that precludes subnational governments from exercising the autonomy associated with the potential benefits of decentralization.

One potential solution is to adopt an implementation process in which subnational governments are allowed to exercise greater fiscal autonomy or receive additional resources as they meet certain criteria. The implications for PFM reform, for example, might be to impose greater ex ante control on subnational fiscal decisions in the early stages of decentralization. As subnational governments demonstrate improved fiscal performance, the system can evolve toward greater reliance on ex post controls.

If capacity and readiness vary across jurisdictions at the same level, an asymmetric approach could be used, such that entities with demonstrated capacity are allowed to move faster toward greater autonomy than peers with less capacity. Asymmetric arrangements are often well suited to larger or more advanced urban centers, which are often better prepared to take on additional responsibilities. PFM-related triggers, such as complying with specific reporting and auditing requirements, could be used to guide such processes.

For example, the Public Debt Law of Kosovo allows municipalities to borrow if they have received an unqualified audit opinion from the auditor general for the previous two years. When the law came into effect in early 2010, only the capital, Pristina, was in a position to borrow.

6See, for example, de Renzio (2011) on PFM reforms and Eaton, Kaiser, and Smoke (2011) on decentralization reforms. 
7Some attention to the implementation of decentralization may be found, for example, in Smoke and Lewis (1996); Bahl and Martinez-Vázquez (2006); Shah and Chaudhry (2004); and Smoke (2007, 2010).
Another type of strategic approach ties funding levels to compliance with certain financial or administrative requirements. Kenya’s current Local Authority Transfer Fund, for example, is allocated by an objective formula, but the allocations can be reduced if local governments do not meet certain PFM requirements (Smoke, 2003). More broadly, performance-based grants have been used in countries such as Uganda to create various broader performance and capacity-building incentives for local governments. None of these examples involves the adoption of an overall strategic approach, but the strategic elements inherent in each can provide guidance to reformers contemplating more comprehensive reforms.

12.1.6. Role of International Development Partners

International development partners have played a significant role in many public sector reform programs in developing countries, including those related to PFM and decentralization (Development Partners Working Group on Decentralisation and Local Governance, 2011). The development partner efforts have had two particularly pronounced effects. First, they have often been the driving force behind the imbalance discussed in the preceding subsection between attention to design and attention to implementation. Although more attention is now given to implementation, few countries seem able to create strategic implementation processes and use them effectively.

Second, international development partners are diverse and have their own objectives and priorities. In pursuing their respective objectives, it is not uncommon for them to generate new tensions or reinforce existing tensions between government agencies in charge of various aspects of public sector reform. Development partners have occasionally pursued PFM reform with little attention to decentralization reforms being supported by other development partners or different departments of the same agency (Uganda is one such example). Individual aspects of reform are difficult enough to deal with, and better coordination across reform areas is even more challenging. However, without improving coordination, the danger of wasting resources and placing reform programs on a collision course becomes even greater.

12.2. LEARNING FROM COUNTRY CASE STUDIES

This section reviews and compares three country cases. It illustrates how contextual factors, including political economy incentives, affect the nature and relative priority of the decentralization and PFM reforms being pursued. It also tries to document the positive and negative results to date in each country and their underlying causes and influences. Finally, suggestions are made for how the PFM–fiscal decentralization reform link might be improved in each case. These cases were selected because they illustrate different starting points and approaches.

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8 See Steffensen (2010) for a detailed explanation and examples of performance-based grants used to date. Lewis and Smoke (2009, 2012) review the literature on other types of performance systems.
to decentralization and PFM reforms and because sufficient information is available to highlight details of useful issues. They are intended to provide a selective rather than an exhaustive illustration of the different approaches to decentralization.

The cases are

- **Indonesia**, which formerly had a deconcentrated system under strong central control that was rapidly and significantly devolved under a so-called big-bang reform in the wake of a major political and economic crisis;
- **Kosovo**, where significant PFM improvements took place ahead of an ambitious—and politically motivated—decentralization reform; and
- **Uganda**, where a major political shift allowed the development of a shared consensus and framework for strong local government, the support for which dissipated over time.

### 12.2.1. Indonesia

As in many ethnically diverse countries colonized by European powers, building national unity through centralization was a priority after independence, creating in Indonesia the foundation for the authoritarian Suharto regime. Attempts to decentralize in the 1970s and 1980s, often donor promoted, never gained political traction and largely involved deconcentration. In the aftermath of the 1997 Asian economic crisis, amid rising political tensions between the provinces and the center, the post-Suharto government pursued decentralization to hold a very diverse and weakly unified country together. The government enacted a decentralization framework and adopted what has been called a big-bang implementation approach. Reform primarily empowered local governments in reaction to fears that strong provinces would generate regional conflicts, separatism, or federalism.

Indonesia has three levels of government—the central government, 33 provinces, and 510 local governments—and a relatively advanced decentralization framework.11 The legal framework introduced in 1999 and 2000 eliminated hierarchical relationships between local governments and higher levels and defined responsibilities of each level.12 It devolved many functions, with only defense, foreign affairs, justice, monetary policy, finance, police, development...

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9 Indonesia is the fourth-most-populous country in the world, comprising more than 17,000 islands, and more than 200 languages.
10 There are two types of second-tier subnational governments, cities (kota) and districts (kabupaten). Since the 2001 reform, the number of subnational governments has increased, and it is expected to continue to do so (IMF, 2009).
11 For more detailed discussion of fiscal decentralization in Indonesia, see Lewis (2003, 2005, 2006); Alm, Martinez-Vazquez, and Indrawati (2004); World Bank (2005); Kaiser, Pattinasarany, and Schulze (2007); Lewis and Oostermann (2008); Lewis and Smoke (2009); USAID (2009); and Lamont and Imansyah (2012).
12 For details of the legal framework, see Laws 22 and 25 (1999) and Law 34 (2000); Law No. 28 (2009); and the constitutional amendment of 2000.
planning, and religion reserved for the center. Local governments must provide health, education, environmental services, and infrastructure, and may provide other services not legally reserved for higher levels. The provinces became responsible for services spanning multiple districts. As a result, subnational governments manage almost one-third of total public expenditures and carry out about half of total development expenditure.

Subnational revenue sharing is generous, but own-source revenues are weak relative to local government responsibilities. Subnational revenue is a general allocation grant fund based on a minimum of 26 percent of central government revenues, which accounts for about 60 percent of all transfers. The allocation of this grant to individual provinces and local governments is determined by a formula, with the latter receiving 90 percent of the pool. Even though the formula includes a redistributonal component, it is not enough to affect the overall disequalizing impact of the system (IMF, 2009). Revenues from income taxes, the land and building tax, and natural resources receipts (oil, gas, mining, and so forth) are shared between the center and the subnational governments according to defined criteria that are primarily origin based. In addition, special allocation grants are allowed for earmarked transfers. Their share of total grants from central government is small but increasing.

Subnational own-source revenues were limited in the original decentralization law, but they are considerably more substantial for provinces than for local governments. The 2000 regional taxation law expanded the scope for own-revenue and allowed local governments to introduce new taxes. Local governments, however, adopted unsatisfactory revenue sources that were contested, and a new subnational revenue law in 2009 created a more prescriptive framework. This law did devolve the land and building tax, which is to be phased in through 2014, but local governments are not obligated to collect it. Some may not have the capacity to do so, and some may not need to do so given the generous revenue-sharing arrangements and lack of incentives for own-source revenue generation.

Local governments once borrowed extensively, mostly through mechanisms controlled by the ministry of finance. Although this was an improvement over the system it had replaced, it was still insufficient for robust local financing of much-needed infrastructure investment. Because local government borrowing performance deteriorated over time, with both poor loan allocation decisions from the centralized mechanisms and poor repayment, local borrowing remains limited. Reform on this front has been slow, largely owing to internal disputes between ministry of finance departments over control of local government borrowing.

On the PFM front, Indonesia has not faced the same serious challenges to the subnational financial management system that have plagued a number of decentralizing countries. The PFM system was centralized in the Suharto era, and the systems and staff were initially transferred to the newly empowered local

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13 See Smoke and Sugana (2012) for a recent detailed review of the revenue system.
14 According to the 2009 budget, outstanding loans of regional government at end-2007 (on-lent foreign loans and domestic loans from the central government) amounted to 0.02 percent of GDP.
Local governments keep their own budgets and bank accounts, subject to national regulation.

Overall, there has not been a major disconnect between PFM and decentralization, and many of the improvements adopted in the local government financial management system have attempted to move the system in a better direction. The immediate fiscal effects of decentralization were not disruptive because the basic PFM system remained in place, a substantial portion of local government staff was transferred from the deconcentrated bureaucracy, and as noted above, local governments had limited revenue autonomy. Thus, some historical factors and design features, regardless of whether intentional, constrained local fiscal autonomy, forestalling problems sometimes experienced with extensive and abrupt decentralization.

Despite the overall positive picture of a major rapid decentralization that avoided some of the fiscal challenges critics feared, issues remain. Beyond the challenges posed by weak local revenue autonomy and a nearly dysfunctional subnational borrowing system, a number of central government ministries continue to provide services that are supposed to be local functions, and subnational service performance delivery is highly uneven. Large aggregate local government surpluses (detailed figures for individual local governments are not available) suggest that some local governments do not have the capacity or incentives to meet their responsibilities effectively. In 2004, new laws weakened local government budgeting and civil service control, partly in reaction to lack of performance.

Although an established PFM system and diagnostics exist on paper, issues have also arisen on this front. Difficult debates between the ministry of finance and the ministry of home affairs have occurred over responsibility for the development and oversight of the subnational financial system. The capacity of local governments to operate that system effectively varies considerably, and the level of monitoring and reporting on outcomes is inadequate. Weak fiscal reporting capacity at the subnational level continues to limit fiscal policy management and coordination. State Finance Law 1/2003 prescribes that the consolidated central and local government budget deficits be limited to 3 percent of GDP, and that general government debt not exceed 60 percent of GDP. The central government has not established mechanisms for allocating fiscal objectives between central and local governments and ensuring compliance with the law. Moreover, the government is unable to monitor and report on its performance against these fiscal rules owing to the lack of timely general government financial statistics from subnational governments. Subnational governments are required by law to submit their budgets regularly and to report on budget execution to the central government, but long delays occur—sometimes as long as two years on the execution side—making it difficult for the ministry of finance to monitor local financial operations. In addition, development partners provide a variety of capacity-building activities for local PFM that differ somewhat in approach and geographic coverage, have not been comparatively evaluated, and are seen by some analysts as failing to support the development of a standardized national system.
Two broad issues underlie these weaknesses. First, Indonesia never established a coherent strategy or coordination mechanism to operationalize and implement its fiscal decentralization framework. A ministerial-level Regional Autonomy Review Board was empowered to design policy, but it is no longer influential. The ministry of home affairs has the strongest official role, but other central agencies, such as the ministry of finance, the national planning agency, and sectoral ministries, do not fully accept the ministry of home affairs’ leadership. Overall, the coordination of decentralization policy remains weak and reform progress on some fronts is ad hoc and erratic rather than strategic and progressive.

Second, the development of subnational government accountability mechanisms is complex and difficult. Local civil servants accustomed to looking to their parent ministries are learning to pay more attention to elected local government councils. The councils are learning to deal with the civil servants who are supposed to report to them and the citizens who elected them, and citizens are learning how to hold councils and service providers accountable. Insufficient attention has been paid, however, to strategically fostering these accountability relationships critical to securing the potential benefits of decentralization and creating an environment conducive to further relaxation of central control over local government fiscal activities.

How Indonesia will deal with the need to develop decentralization more strategically, coordinate the central actors, improve horizontal and downward accountability, and further develop and institutionalize PFM and other technical capacity at the local level will determine how effective and fiscally responsible decentralization can be in the future. The government of Indonesia is starting to give more attention to the challenges of local governments and is considering a number of reforms and incentives to improve their performance, including experimenting with performance-based transfers, but none has yet gathered significant momentum.¹⁵

12.2.2. Kosovo

Fiscal decentralization in Kosovo is a political necessity. The Comprehensive Settlement Proposal¹⁶ contains a blueprint for local self-government largely inspired by European models; by allowing municipalities significant autonomy, and even greater latitude to Serb-majority municipalities through asymmetric arrangements, the settlement seeks to promote democracy and mend ethnic tensions. Underpinning decentralization, territorial reorganization of municipalities—

¹⁵The papers from a conference marking a decade of big-bang decentralization in Indonesia and considering its future are presented in Lamont and Imansyah (2012).

¹⁶Since the end of the conflict in 1999, various attempts had been made to secure agreement with Serbia. The “Comprehensive Proposal for the Kosovo Status Settlement” (presented to the UN Security Council by Special Envoy Marti Ahtisaari in March 2007) failed to gain consensus and was subsequently withdrawn owing to a veto threat by Russia in the summer of 2007. The Kosovo government unilaterally declared independence in February 2008, and is implementing the proposal as its main political strategy.
the basic units of local self-governance—has proceeded rapidly. Political municipal elections for municipal assemblies and mayors were held in the 36 municipalities in November 2009, but were boycotted in three of the Serbian-majority municipalities in the country’s north.

Although legislation grants municipalities significant competencies in key areas, most notably health care and education, their revenue autonomy has remained severely limited. Own-source revenues are scarce and poorly administered. The main local revenue handle, the property tax, is affected by low compliance rates and inadequate administration.

The move toward greater decentralization coincided with increasing macrofiscal pressures. Growth stagnated in 2009, and fiscal imbalances have grown. Following the enactment of municipal finance legislation in 2008, central grants to municipalities have increased by more than 50 percent, leading to a sharp rise in municipal spending (also driven by the political cycle); at the same time, own-source revenues have remained virtually flat (the sharp increase in transfers may have weakened collection incentives). Thus, decentralization is creating tension between the need to ensure fiscal discipline (in a country that has adopted the euro and aspires to join the European Union) and the demands of and opportunities for greater autonomy for subnational governments.

PFM reforms preceded decentralization, and later came to support it. As Kosovo set out to rebuild its institutions following the conflict with Serbia, modern budget processes were introduced, including a comprehensive well-functioning centralized treasury system that enables production of timely and reasonable analytical reports (World Bank, 2007).

Local government budgets are executed through the central treasury system, and treasury control over local government spending levels has generally been effective. Municipalities are fully covered by the treasury single account (TSA) system (see Chapter 9 for a discussion of TSAs). All municipal revenues are transferred to the TSA on a daily basis, and all expenditures are paid from the TSA. The treasury system is also the main source for reporting on municipal finances.

Central control, however, which has been viewed as the cornerstone of ensuring sustainable public finances and was welcome in the early days of decentralization, will need to adapt to the new reality of greater municipal autonomy. Municipalities have been resenting what they view as excessive interference by the central government in their own affairs; in turn, the central government has relied on tight execution through the central treasury to control municipal finances. The result is suboptimal consultation and limited joint coordination on fiscal policy among government levels. As political and fiscal decentralization deepen,

17 Municipal expenditure as a share of GDP rose by almost 2 percent of GDP during the period 2007–09. See Fedelino and Ter-Minassian (2010) for further details.
18 A standard TSA is a bank account or a set of linked bank accounts through which the government (and its entities and spending units) transacts all receipts and payments and consolidates its cash balances. See Box 9.1.
the central government will need to transform its PFM toolkit from heavy reliance on ex ante control to the development of ex post accountability mechanisms.

This transformation will not be easy. Although seemingly paradoxical, it is well accepted that effective fiscal decentralization requires strong central government institutions. Fiscal decentralization requires assigning more decisional and operational powers to municipalities. In this process, however, central government needs to ensure that national priorities are respected and needs to retool itself to adapt to its changing functions. Thus, the impact of decentralization must be assessed not only with regard to local governments, but also with regard to the critical need for capacity building in the central government to manage the post-decentralization environment.

Kosovo has not yet given these needs sufficient attention. Ministries affected by decentralization could approach the shift from policy implementation to monitoring and evaluation of the implementation of decentralized competencies by, for example, setting realistic service standards and supporting their monitoring and evaluation.\(^{19}\) Comparative experience shows that in a run-up to decentralization, line ministries often focus solely on the preparation of transfer of competencies, and only later worry about their ability to manage the ensuing environment. The experience in Kosovo indicates that this transition will take much longer than the relatively compressed period that has been mandated to formulate and pass the complex body of legislation underpinning political and fiscal decentralization.

12.2.3. Uganda

Uganda has received a great deal of attention in the decentralization literature as a developing country that embraced genuine and significant decentralization with an unusual level of enthusiasm (Smoke, 2000; UNCHS, 2002; Onyach-Olaa, 2003; UNCDF, 2003; UNDP, 2003; World Bank, 2003; USAID, 2009; Muhumuza, 2006; Okidi and Guloba, 2006; Asiimwe and Musisi, 2007; Smoke, Muhumuza, and Ssewankambo, 2010). Following an extended period of internal conflict after gaining independence from Great Britain in 1962, Uganda began an era of greater stability with the rise to power of Yoweri Museveni and the National Resistance Movement in 1986. Museveni quickly moved to establish the foundation for a functioning state and adopted an extensive program of public sector reform.

Decentralization received more attention than PFM in the early stages of the National Resistance Movement period. From the beginning, citizen engagement and local capacities were emphasized as key drivers of economic development and political legitimacy.\(^{20}\) Decentralization was portrayed as critical for democratization,
service delivery, and poverty reduction. More fundamentally, the National Resistance Army, which prevailed in the 1980s conflict and brought the National Resistance Movement to power, built its base of support with village-level National Resistance Councils, which became the inspiration and model for local government. By the late 1990s, a strong legal framework for decentralization was in place, and local governments quickly became among the most empowered and best financed in Africa.

Although local governments were originally given substantial resources and autonomy, they always relied heavily on intergovernmental transfers. The transfer system was originally designed to cover the recurrent budget. A capital expenditure transfer was set up with donor funding as a somewhat parallel system closely linked to participatory planning and compliance or performance-based conditions. This transfer was later subsumed under a broader capital budgeting process when the government began to gradually decentralize the development budget in 1999–2000. Both recurrent and capital transfers occur as of 2012, and both can be conditional or unconditional. Over time, however, the balance has dramatically shifted toward conditional transfers (more than 90 percent in 2012), and grants have decreased as a share of total public expenditure (from more than 25 percent in 2004 to a projected 18 percent in 2013) and GDP. This rebalancing is only one indication of a broader pattern of recentralization that has been occurring in Uganda in recent years.

What accounts for this transformation? First, after several years of reform, central agencies that originally supported (or did not overtly oppose) decentralization began to realize its implications for their control over resources, and some acted to protect their territory. Sectoral ministries under the mandates of the National Poverty Reduction Strategy and the Medium-Term Expenditure Framework began to develop Sector Wide Approaches that increased standards, monitoring, and central control (Jeppsson, 2002; Kasumba and Land, 2003; Wunsch and Ottemoeller, 2004; Ahmad, Brosio, and Gonzalez, 2006; Smoke, Muhumuza, and Ssewankambo, 2010). The ministry of finance, planning and economic development (MoFPED) also advanced PFM reforms, but they initially paid little attention to local governments or to the separate system of local PFM developed and implemented by the ministry of local government. The MoFPED finally focused on subnational PFM and made the contentious decision to replace the new system with one more consistent with national PFM reforms, which required the retraining of local government officials.

Second, emerging documentation of poor expenditure management processes and service outcomes in the late 1990s led to concerns that too many responsibilities and too much autonomy had been decentralized too quickly (Ablo and Reinikka, 1998; Jeppsson, 2001; Reinikka and Svensson, 2004). This empirical evidence reinforced the perceived need for various central ministries to take steps to recentralize and particularly caught the attention of the donor community,

\[21\] Smoke, Muhumuza, and Ssewankambo (2010) review these issues in more detail.
which was contributing heavily to many of the public sector reform and service delivery initiatives associated with the National Poverty Reduction Strategy. All of the new reforms, however, focused almost exclusively on reimposing upward accountability, with little attention to the equally or more important challenges of building the downward accountability to citizens required for effective decentralization.

Third, the political weakening of the National Resistance Movement and the emergence of multiparty elections led to a number of reforms to support electoral strategies and strengthen central controls that reinforced the effects of the technical reforms outlined above (Green, 2008; Muhumuza, 2008). These reforms included extensive creation of new local governments (districts) with little capacity, recentralization of procurement and recruitment of senior local government staff, and formal establishment of regional governments (albeit with limited action taken to set them up) that had been abolished to deal with perceived challenges to national unity posed by traditional kingdoms (regions) and to emphasize the empowerment of the local governments.

Finally, the behavior of some of the development partners created challenges for decentralization. Even when the donors supporting decentralization were working together, they focused their efforts on the relatively weak ministry of local government and did not sufficiently work with other ministries that needed to be on board. In some cases, different departments of the same development agencies supporting decentralization were pursuing PFM or sectoral reform efforts at odds with the legal framework for decentralization and the donor programs supporting it.

The Decentralization Development Partners Group commissioned a study to consider how to reintroduce discretion and improve performance. This study resulted in the 2002 Fiscal Decentralization Strategy, which introduced new budgeting and financial management processes. This strategy improved information and monitoring, but it also imposed a budget template that largely reinforced the limited budgetary discretion of local governments.\(^\text{22}\) The Fiscal Decentralization Strategy formally provided for some flexibility that was substantially stifled in practice, and its stated intention to loosen restrictions after local government capacity was built was never implemented.

Ultimately, decentralization in Uganda was pursued initially for political reasons and in isolation from other public sector reforms, including PFM, that have now overwhelmed it. The nature, pace, and trajectory of reform was clearly too ambitious to take root and result in vigorous performance, owing to both insufficient capacity and inadequate accountability pressures. Excessive emphasis was probably placed on formal system development and insufficient attention given to building local capacity, accountability, and governance.

In short, PFM reforms in Uganda during the past decade, including the Fiscal Decentralization Strategy, have undeniably improved information, monitoring,
and fiscal discipline. These achievements, however, have come at an unnecessarily heavy price—the considerable undermining of local governments’ autonomy and ability to respond directly to the expressed needs of their constituents. Going forward, the benefits of PFM reforms can be maintained and the benefits of decentralization realized if the right actors can be engaged to develop a strategy for gradual reintroduction of local autonomy and performance incentives to retain and improve fiscal responsibility. Given the political situation in Uganda, however, and the discovery of oil, primarily in the more powerful and assertive traditional kingdoms, the challenges in the coming years will be considerable.

12.3. GENERAL LESSONS LEARNED

This section highlights strategic considerations that could help analysts understand the interconnections between PFM and fiscal decentralization and how they might be improved to yield better results. Generalizations are difficult, given the diversity of context discussed in the case studies and the limited empirical evidence about what works well in practice. Still, this section offers a few simple principles for consideration, with the caveat that they involve a certain amount of simplification and need to be used and developed as appropriate for specific cases. Some of these points may appear intuitive, but despite how obvious they may seem, they are rarely adequately considered in policy circles. Even though the recommendations are general, much can be gained from this type of analysis, and those responsible for decentralization and PFM reforms have a responsibility to undertake such efforts. Further work is needed to develop a more robust framework.

First, Pay More Attention to Context When Considering How to Frame and Implement Normatively Desirable PFM and Decentralization Reforms

PFM and decentralization reforms have frequently been pursued in a way that is too heavily based on purist principles or on borrowed approaches from other countries. Moreover, the reforms have often been undertaken without an assessment of broader international experience or an in-depth diagnosis of the prevailing country-specific political and institutional context and its implications for workable subnational PFM and decentralization reform options. This was clearly the case in Uganda. Gaining an understanding of the underlying motivations for and objectives of both types of reform is crucial, as is determining which entities (across and within levels of government) will be receptive to these reforms and have the capacity to bring them to fruition.

Equally valuable is assessing whether existing PFM and subnational government systems can be reformed or whether a completely new system needs to be developed. In either case, some positive features of the existing system may be working well, but are sometimes lost as reforms and new systems are developed. Although it may be easier—and tempting—to turn the page and start new,
normatively inspired reforms from square one, in practice, using and adapting existing systems may secure more rapid, more robust, and ultimately more sustainable results.

Second, as Much as Possible, Embed Technical PFM Reforms in Broader Public Sector and Decentralization Reforms

Decentralization involves a broad array of roles and reforms beyond the fiscal arena—administrative, political, and regulatory, among others. PFM reformers commonly tend to perceive technical PFM reform as a prerequisite for other reforms. For decentralization, they may even argue that no functions and resources should be given to local governments until the necessary systems, procedures, and capacity to manage them effectively are fully in place. National agencies generally have stronger technical expertise and do need to ensure that the evolving intergovernmental system follows established procedures and standards. Developing sufficient local capacity requires resources and time, suggesting an inherent tension between this overarching PFM approach and the rapid adoption of decentralization.

The normative position that PFM reform should always precede decentralization will sometimes be at odds with political reality—countries with a strong political imperative for decentralization (for example, when emerging from conflict) do not have the luxury of waiting for an ideal PFM system to be developed before advancing decentralization (as the experience of Kosovo shows). Moreover, from a local government and citizen perspective, if local governments are going to be created, they need to be doing something, even if very basic, to establish their credentials in delivering services to meet the needs of the citizens they represent. A neat, orderly, sequenced comprehensive PFM reform process in advance of empowering local governments does not meet this need, and electing and paying local councils simply to learn how to budget and keep financial records is unlikely to be politically viable and may even undermine decentralization efforts.

However, linking PFM reform to broader decentralization reform should be possible, giving local governments simpler but visible functional responsibilities early and allowing them to learn commensurate basic PFM skills. Cambodia is an example in which initial piloted (and parallel) reforms at the local level were progressively formalized and rolled out. As the system develops and capacity is enhanced, a higher level of PFM skills can be built along with the devolution of additional service functions and resources. In short, the scope and pace of decentralization could proceed in tandem with the capacity of subnational governments to perform functions assigned to them, and new PFM initiatives could be aligned and embedded in broader decentralization reforms. This is a win-win approach in which local governments are not given functions without adequate PFM safeguards but are able to perform some functions that establish their legitimacy and create a foundation for further fiscally responsible reform. The failure to adopt such an approach was one of the critical factors that led to the recentralization in Uganda.
Third, Ensure That a Well-Grounded Strategy for Pursuing Reform Programs Is in Place

Building on the notion that PFM reforms can be linked to specific functions undertaken by local governments as decentralization proceeds, such as service delivery or revenue generation, identifying the appropriate steps becomes important. A good starting point would be reforms that can be executed with a high probability of success, which may be simpler types of functions and processes, although the decision ultimately depends on the systems and capacity in a particular country.

A second step would be to build on these initial functions strategically in successive rounds of reform, subsequent to careful monitoring and assessment of initial steps. Appropriate incentives for local governments to adopt new functions and more advanced PFM processes can be usefully employed. Creative ways of structuring reforms and partnerships that hold some promise for learning and results should be sought. An example is working with spending ministries to devise plans for the progressive functional devolution in a particular sector or partnering with nongovernmental organizations or private firms in ways that assist local governments to better meet their assigned functions.

Fourth, Build Capacity Necessary for the Specific Steps of the Implementation Strategy

Although only mentioned in passing in the preceding analysis, much capacity building in decentralization and local government PFM is generic, classroom-based training. Such training is often so different from what local government officials are used to and so poorly reinforced through subsequent support that concepts and skills taught in training courses are frequently lost or muddled when officials get back on the job. A more productive approach would be to target capacity building to the more limited functions and tasks that will be immediately used. Once these skills are mastered and institutionalized, additional skills can be developed as more significant and challenging functions and tasks are assumed. Providing periodic, on-site follow-up technical assistance can also help to keep learning on track and to deepen and reinforce skills and capacities.

In decentralization, two additional considerations must be recognized. First, as emphasized in the country cases, central government officials implementing decentralization and supporting or regulating local governments also require training to fulfill their new roles effectively.

Second, local capacity building needs to be both technical and governance oriented. Local governments must receive training to meet their functional responsibilities and maintain fiscal discipline. And citizens, elected officials, and local government staff must be trained to work with each other under new accountability relationships generated by decentralization. The best system and greatest technical capacity do not result in the expected advantages of decentralization unless the behavioral changes underpinning the attainment of these advantages occur. Local government staff, who may have previously looked to the
center for direction, must learn to work effectively with elected local councils, who must be able to engage with budgeting and financial management processes and be responsive to their constituents. Similarly, citizens need to understand how local government resources are managed and accounted for. Citizens may even be involved in this process directly, through participatory planning, budgeting, or monitoring.23 The experience in Uganda highlights how failure to establish adequate accountability channels and capacity at the local level can undermine decentralization reform and require later redressing.

Fifth, Consider Innovative Mechanisms and Approaches That May Help to Facilitate Successful Implementation of Reforms

Public sector reform tends toward standardization, but asymmetric approaches can sometimes be valuable. The possibility was noted above that decentralization and PFM reforms can be differentially targeted to specific types of local governments (e.g., large metropolitan areas versus small rural districts) or based on specific performance or capacity measurement (see Chapter 7). Local governments may also be allowed a degree of choice in defining and pursuing specific reform trajectories, so that they assume responsibility for what they agree to do rather than simply being told what to do by the center.24

Enforceable accountability mechanisms, such as central government contracts with local governments to undertake certain reforms, hold promise. Financial incentives for adoption of reforms and improvement in performance, for example, the emerging wave of compliance or performance-based grants being adopted in the developing countries referred to above, may also be used to increase the effectiveness of decentralization and subnational PFM reforms.

Sixth, Identify and Work With the Supporters and Opponents of Reform and Take Steps to Coordinate the Various Actors

PFM and decentralization reforms are staged in a crowded arena: multiple national agencies are typically at odds, pursuing disparate agendas (often with support from different external donors). The ministry of finance is positioned to play the leading role in ensuring that subnational PFM systems are robust and adhered to even where subnational levels have substantial fiscal autonomy, but many other actors are relevant. These significant players include ministries involved in local government oversight and support as well as those in charge of civil service regulations and those responsible for ensuring that standards are met in the delivery of specific public services with national significance (such as health, education, public works, or other sectors). All of these actors need to be keenly involved in the political discourse surrounding the development of decentralization and the process of reform itself.

23 See Brinkerhoff and Azfar (2010) for a discussion of governance dimensions of decentralization.
24 See Smoke (2007, 2008b) for more discussion and examples of asymmetric decentralization.
Given the large number of actors, the creation of effective coordination mechanisms for decentralization by itself is difficult enough and, of course, decentralization is seldom the only or most important driving force in public sector reform (Smoke, 2010). The problems caused by weak coordination of public sector reforms can be so significant, however, that the potential benefits of improving coordination mechanisms are great.

12.4. CONCLUSION

This chapter pushes the boundaries of conventional discourse on the links between PFM and decentralization reform, with a particular emphasis on developing and transition countries. In an ideal world, PFM reform and decentralization reform would have a strong conceptual and practical relationship. In such a world, PFM systems would be designed and implemented to support and enhance the allocation and sharing (whether immediate or eventual) of the responsibilities for managing public functions and resources across government levels.

In reality, this ideal relationship is generally not well established nor put into operation. Every major force that drives one of these reforms collectively challenges the realization of a seamless coordination between, and sequencing of, decentralization and PFM reforms. Even at a more pragmatic level, reformers cannot always afford the luxury of implementing normative principles in a well-sequenced and highly coordinated manner and over a long time span. Thus, decentralization and PFM often proceed separately, and at times in fundamentally inconsistent ways. This tendency is reinforced by the landscape of shifting political and economic conditions, reform objectives, and actors (domestic and external) involved in the reforms.

Although no single solution to this consequential policy dilemma is evident, this chapter highlights some key issues and strategic considerations that could help analysts to understand more systematically the PFM–fiscal decentralization linkages. It outlines some basic principles that use both old and new ways of contemplating how PFM and decentralization reform can work together more effectively. Recognizing the limitations of this analysis and the need for further work, this chapter is not naively suggesting that the generic approach outlined here is uniformly desirable, easy to accomplish, free of transaction costs, or fully attainable even in the most favorable circumstances. However, more formal, methodical analyses of these issues are clearly important. Much more effort in this direction is well within the reach of motivated policy analysts and reformers. Accepting the challenge to deal with these important reforms more systematically holds great promise for improving public sector performance.

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Associate Professor of Public Policy,
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