MANAGING PUBLIC FINANCE AND PROCUREMENT IN FRAGILE AND CONFLICTED SETTINGS

Doug Porter, Matt Andrews, Joel Turkewitz and Clay Wescott

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Introduction

Over the past two decades, global responses to conflict have become pre-occupied with the high probability that enduring fragility will turn to violence. This is in marked contrast with the experience of conflicted states in the aftermath of the Second World War, where strong incentives existed for elites to invest political and administrative capital in systems for effectively managing public finances. As a result, these systems became legitimate sites for social contest about what resources would become public revenue, how they would be allocated and used to procure particular outcomes, and about who would be held to account for the effects of those decisions. Indeed many have suggested that successful ‘societal evolution’ hinges on the systems and procedures societies develop to manage public finance and procurement (e.g., Bates 2009; Schumpeter 1991(1918); Tilly 1992; Scott 2009; Therkildsen 2002; Moore 2004).

In today’s fragile and conflicted states, this process is slow and the trajectory uncertain. Many have achieved a sustained turn-around (Chauvet and Collier 2006, Table 1), but as often they suffer from a long term “shrinkage in effective public authority” (Moore et al., 2009). In these contexts, authoritative power shifts from the state to actors who draw on a range of illicit, donor and state resources in ways that ensure that formal systems for public finance management and procurement remain functionally weak, painfully slow and unreliable, and widely contested and corrupted. The legitimacy of these core state institutions is undermined by perceptions that they are both unjust procedurally and ineffective in delivering results (Levi and Sacks 2009).

Anticipating that this condition is chronic, donors consistently respond by installing tough parallel modalities to deliver and protect their resources against fiduciary risks, corruption and criminality. Alongside, propelled by a strong normative consensus about what kinds of formal institutional arrangements are most desirable, a four part cascade of reforms is introduced to create the legal framework, the institutional architecture, the operational systems and human capacities, and the control and disciplinary arrangements.¹ The premise is that adopting such institutional forms - otherwise known as ‘building capacity’ - will make it possible for fragile states to effectively raise and convert resources into services, and thus contribute to state legitimacy and authority. A ‘transition’ is hoped for. As the newly installed mainstream arrangements begin to demonstrate their efficacy, the parallel modalities will become aligned with them and eventually dissolve into the core institutions responsible to manage and convert finances into goods and services. More often, however, the parallel modalities remain and continue to cast shadows over the formal institutions. The latter may be backed by the confidence of new laws and formally established organizational arrangements, and by official declarations that they will soon be rolled out in practice. But they fail to deliver functionally as they are crippled by a combination of neglect, the continuation of parallel systems and the prevalence of quasi-formal systems and practices. Indeed, for the most part, to achieve results, governing elites manage public finances through an array of semi-official and darker systems where decisions are made more by precedents than law, and according to prices reliably established on informal markets of patronage. In
this, weaknesses in core state systems become more pronounced, and perverse incentives are created for governing elites to extend social contest and bargaining far beyond formal state institutions.

We illustrate aspects of these points in Section 1, finding a disconnect between the laws, rules and procedures adopted for better public finance and procurement and their actual functionality. Section 2 suggests that changes in the in the nature and volumes of resource flows, both domestic and international, have affected the incentives to which governing elites respond in fragile settings. The case of Cambodia is presented to illustrate the long term effects of the choices made in early stages of peace building. Finally, we suggest in Section 3 that the central challenge in public finance and procurement interventions is to positively influence the incentives to which elites, national as well as local, inside and around public authorities, respond in contexts of fragility.

Section I: PFM in fragile and conflict affected states: the record

There are no composite measures tailored to comparative analysis of public finance management in fragile or conflicted settings. The Public Expenditure and Financial Accountability (PEFA) Performance Measurement Framework however provides a useful point of reference, for two reasons. It provides us with an empirical reference to compare countries affected by conflict and fragility with other non-fragile poor countries. Second, the PEFA system reflects an international consensus amongst donors on “the immediate objectives of reform” (Wescott 2008, 22). It is presented as a tool countries can use to benchmark their PFM system against “existing good international practices” (PEFA 2006, 5). The PEFA framework disaggregates this consensus into 64 PFM process dimensions (listed in Annex 1) that are described as “critical” to the “performance of an open and orderly PFM system” and are generally recommended “for all countries to achieve sound public financial management” (PEFA 2006, 2).

Fragile states do not fare very well on the PEFA indicators

The impact of fragility on PFM process quality is apparent when reviewing data for the 101 countries (listed in Annex 2) that had completed at least one PEFA assessment by February 2010. Scores on the 64 PEFA process dimensions in the nineteen fragile countries (classified as such according to IMF criteria) average 1.73 as compared with 2.26 for non-fragile countries—where a “1” is the lowest score (a D rating) and a “4” is the highest score (an A rating). Ostensibly a higher score implies convergence around good international practice. The fragile state group scores below the non-fragile state group on all 64 dimensions, as illustrated in Figure 1. These gaps illustrate the ‘costs of fragility’, which are greater in respect of some dimensions than others.

Figure 1. PEFA score gaps between fragile and non-fragile countries
Process gaps tell a compelling story about reforms

Fragile countries score within a half point of non-fragiles on some PEFA dimensions. But more interesting is that both sets of countries score well in some dimensions, like PI 27(iv) which relates to the rules for in-year budget amendment, PI 8(i) pertaining to rules for budgetary allocations to sub-national authorities, and PI 5 where countries score higher where they have formalized modern budget classification systems. On another set of dimensions, both country groups score poorly. These include PI 12(iv) which measures the extent to which macroeconomic forecasts are linked to actual investment decisions, PI 21(i) where countries are assessed based on the actual coverage and measured quality of internal audit reports, and PI 28(iii) which measures the responsiveness of the executive to the legislature, for instance, whether the legislature issues recommendations based on audits and whether the executive implements remedial action. We will say more about this shortly.

A more revealing way of summarizing these patterns of performance is to distinguish between three axes. These distinguish between:

i) progress with adoption of de jure measures and de facto functional results. These contrast PEFA dimensions where higher scores can be achieved by a new law, or introducing a new practice (e.g., in PI 11i) a ‘C’ score can be achieved if a rudimentary budget calendar is in place (most often a law), even if not implemented. By contrast, ‘C’ scores can be achieved for several dimensions only with significant de facto engagement (e.g., a C on strategic budgeting (PI 12i) requires that actual forecasts have been developed for at least two years, on a rolling annual basis).

ii) ‘upstream’ and ‘downstream’ performance. The former includes strategic budgeting (multi-year forecasting, strategic planning, investment planning, debt planning); annual budget preparation; legislative analysis of the annual budget; and the structure of formal budget documents. Downstream performance includes resource management (including cash inflow and outflow management, procurement, payroll); Internal control, internal audit and monitoring; Accounting and reporting; External audit; and Legislative analysis of audit reports.\(^5\)
iii) results that require action by ‘concentrated’ and ‘deconcentrated’ entities. The former includes PEFA dimensions under the direct control of central bodies – like the Ministry of Finance – that play regulatory, ‘rules of the game’ and summary reporting roles. Deconcentrated dimensions refer to those where engagement of multiple agencies - actors in line ministries, or sub-national governments responsible for expenditure and accountability for results – and engagement of parliament, external audit and management in executive MDAs.

There is clearly overlap among the three axes – and this illustrates the difference between form and function noted earlier. Our contention is that de jure, upstream and concentrated dimensions are representative of ‘formal’ features of the PFM system. De facto, downstream and deconcentrated, we argue, is more representative of a ‘functional’ adjustment.

Figure 2 shows differences between averages scores on dimensions and indicators assessed to be de facto, de jure, de concentrated, concentrated, upstream and downstream, in fragile and non-fragile groups.

Figure 2. Differences in different dimension types point to reform strengths, weaknesses

Note: Gridlines reflect average scores on the various dimension types, starting at 1 (D) at the center and radiating outwards in increments of 0.5, to 3 at the outer-most gridline.

Figure 2 shows that fragile and non-fragile countries score better on de jure dimensions than they do on de facto dimensions, on concentrated than de-concentrated and on upstream than downstream. The
fragile country group scores show that de jure, concentrated and upstream dimensions average about 2 out of 4 but that the de facto, de-concentrated and downstream dimensions average about 1.5. These gaps resonate with common knowledge.\(^9\) Budget preparation is stronger than execution, governments are stronger on passing PFM laws and regulations than they are on implementing them; and PFM systems are stronger where narrow sets of agents are engaged in their implementation than where multiple, de-concentrated actors are required to achieve functional results. We will, in section 3, consider various actions that may help governments to address these gaps, but it is useful first to look more closely at what we term ‘process weaknesses’.

**Identifying where process weaknesses persist in fragile countries**

To examine more closely the areas of greatest weakness, we isolated 31 African countries in the 101 country PEFA set, with 10 of the 31 being fragile.\(^10\) This analysis re-affirmed our general findings. We found statistically significant weaknesses (a lag by more than 0.75 and where all of the differences are statistically highly significant) in all seven dimensions of political engagement in PFM processes: in preparing budgets, production of forecasts, sector strategies, legislative oversight and direction. All dimensions in strategic budgeting and budget preparation process areas are also significantly weaker. And, in all cases, fragile states are particularly weak in budget transparency and crucial downstream processes like cash management, procurement, payroll control and internal control.\(^11\)

Fragile states in this 31 country sample score relatively better on concentrated PFM dimensions—in areas of budget management, treasury and revenue management, for example—than they do on any other dimensions. This reinforces the observation above, about concentrated agent dimensions performing better than others, and given the turmoil common in the immediately aftermath of conflict, may reflect our observation from experience that small, concentrated cadres in selected areas can be maintained or quickly reassembled – e.g., budget offices or treasuries, staff with returning professionals and international consultants immediately after conflict.

Figure 3 aggregates PFM dimension scores into 18 broad PFM process areas, running from strategic budgeting (MTEF type) across to legislative analysis of expenditures. The figure shows the means for fragile and non-fragile countries in these areas, with eight out of eighteen differences in mean between fragile and stable countries statistically significant at 0.01 and a further six statistically significant at 0.05.
In sum, the three axes depicted in Figure 2 help unpack different aspects of the form and function disconnect in PFM in fragile contexts. First, there is a disconnect between the adoption of de jure measures, in which political elites are engaged in the passage of laws and regulations, policy statements and fiscal instruments, and de facto practices, where fewer political investments are made when laws, policies and instruments remain disconnected from results on the ground and accountability is secured at the political level. The second measure provides a different take on this; the formality of PFM processes is strongest at the centre, concentrated in entities responsible for core finance and treasury functions, but this typically fails to articulate in the plethora of deconcentrated agencies at the sector or local level. And third, what we have termed upstream PFM processes (budget making, etc, etc) tends always to be more heavily invested in, than are the downstream processes of achieving functional results in revenue collection and converting expenditures into services.

Section 2: Explaining the gaps: context, resource flows and PFM modalities

All countries are different, and we must be wary of generalization. That OECD countries have achieved highly functional PFM through a wide variety of formal arrangements (Andrews, 2010), as they do with respect to practically every other feature of governance, underscores the fact that there is no one-best way model around which rich country governments converge to manage revenue and expenditures, or
the procurement process. All systems are continuously evolving in response to the limits of past policies, changing roles and responsibilities of government, theories of public management, political and economic ideologies, and societal contests (OECD, 2009).

In the case of fragile states, explaining the record of better performance is easier than explaining poor performance. Governing elites will seek to derive legitimacy from multiple sources. By their nature, the de jure adoption of upstream PFM measures require fewer actors, and can be achieved by stroke of the pen measures that import readily available global models. That de jure measures feature also highly in externally induced reforms to public finance and procurement is crucially important. Thus, that fragile countries do tend to score better on ‘budget quality’ where external support has been provided may in part be explained by the fact that governing elites are able to garner global legitimacy, and sometimes not inconsiderable local standing by being seen to adopt ‘best practices’. Thus the formality of public finance and procurement processes are one part of the ‘rituals of reason’ used by dependent organizations declare their rationality and endow themselves with legitimacy (Czarniawska-Jorges and Jacobsson 1989; Ezzamel et al., 2007). Formal process of compliance are used to mask the real processes through which resources are raised, distributed and spent (Schick 1998, 128; Rakner et al 2004) in a ‘twilight zone’ that is opaque, core and difficult to influence and change (Wildavsky 1992, 598).

Institutional theory doesn’t say what can be done about this, but it does go some way to explain why downstream functional results that are consistent with PFM doctrine are more difficult to achieve (Di Maggio and Powell 1991, Andrews 2009, Epstein, 2008). At the downstream ‘end’, where expenditures and procurement decisions produce results and accountability, the ‘fit’ between formalism and context becomes most problematic. These transactions involve multiple agencies and individuals acting in deconcentrated environments, at some remove from the centre, and more frequently entail the exercise of considerable discretion in how formal requirements are applied (Fukuyama 2004). That these ‘ends’ of the PFM system are much less affected by donor/external incentivizing is also important, but only part of the story. There is a long tradition of research showing that in transitional contexts political pressures are far less pronounced at the point where laws are enacted than they are at the point of their execution, precisely because in transitional, fragile contexts many pressing demands are not amendable to the legislative process.

It is commonly assumed that fragile countries sport only an exaggerated form of the kinds of weaknesses found in other countries – that is, the problems are merely transitional. We think this underplays key features of PFM in fragile contexts, how they have been affected by global shifts, the nature of the resource flows that PFM must grapple with, and how the modalities employed to manage these resource flows significantly raise the stakes in achieving good, formal PFM systems.

**Global shifts and incentives for reform in public finance and procurement management**

Changes in the global economy since the 1970s have undoubtedly impacted on PFM systems in fragile contexts. The globalization of demand for high value and scarce commodities, (oil, diamonds, minerals, narcotics), the reduced costs of transporting them, the sophistication of illegal networks and the relative ease of hiding financial assets and evading detection, and of manipulating poorly paid officials in fragile countries all significantly ramp up the incentives for personal enrichment. As important, the ability of
poor country elites to secure their interest by private force relieves many of the need to extend their authority by building effective and legitimate formal institutions. The salience of these points becomes more evident when we consider ‘public resource management’ in the wider view of three different resource flows – which we term domestic, illicit and strategic. These, as we will illustrate with reference to Cambodia, significantly affect how governing elites relate to national systems for managing finances and procuring results; in other words, how resource flows structure incentives.13

Resource flows: domestic, illicit and strategic

Domestic resource flows managed within the national budget are amongst the first casualties in conflicted settings. Intuitively it makes sense to prioritize domestic revenue reforms: if people are required to pay taxes they will be motivated to demand more influence over what leaders do, over policy and achieving functional results. There is much debate about this (e.g., Moore 2004, Levi and Sacks, 2009), although the inattention to domestic revenue in policy dialogue between donors and governments is a serious lacunae (Boyce and O’Donnell 2007). But the reality of FCS is that it is difficult to establish ‘fiscally fertile’ zones (Scott 2009, 10), and there are strong political incentives not to do so. History shows that people have resisted state efforts to demarcate, seize, tax or otherwise administer on their behalf natural assets (land, forest fish, minerals), their movements, their labor, to encourage their settlement and registration in taxable villages and their subordination to higher levels of authority (across history, see Scott 2009). Where the dominant rule systems of the state are weakened by conflict, people have created multiple and very durable systems for resisting these kinds of incorporation.

Table 2 Domestic Resources

<table>
<thead>
<tr>
<th>Country</th>
<th>Year ceased</th>
<th>Domestic revenues one year before as % of GDP</th>
<th>Domestic revenues five years after as % of GDP</th>
<th>Domestic revenues ten years after as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>1991</td>
<td>---</td>
<td>6.5</td>
<td>11.7</td>
</tr>
<tr>
<td>Guatemala</td>
<td>1988</td>
<td>---</td>
<td>7.8</td>
<td>9.4</td>
</tr>
<tr>
<td>Haiti</td>
<td>1994</td>
<td>---</td>
<td>8.5</td>
<td>10.4</td>
</tr>
<tr>
<td>Uganda</td>
<td>1986</td>
<td>---</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Liberia</td>
<td>2004</td>
<td>12.6</td>
<td>26.7</td>
<td>---</td>
</tr>
<tr>
<td>Timor-Leste</td>
<td>2000</td>
<td>7.7</td>
<td>12.4</td>
<td>---</td>
</tr>
<tr>
<td>Solomon Islands</td>
<td>2003</td>
<td>16.1</td>
<td>27.5</td>
<td>---</td>
</tr>
<tr>
<td>Mozambique</td>
<td>1993</td>
<td>---</td>
<td>9.9</td>
<td>11.4</td>
</tr>
</tbody>
</table>

Notes: For Uganda, end of conflict is year President Museveni came to power, although battle deaths were 1000 or more in most years through 1991, and in 2002 and 2004. For Liberia, data are for one year before conflict ended, and 4 years after. For Timor Leste, end of conflict is year Indonesian occupation ended; there are no data on battle deaths. For Solomon Islands, end of conflict is year RAMSI mission commenced; there are no data on battle deaths; resources data are for 2002 and 2007. For Haiti, end of conflict is year President Aristide was reinstated, with backing of US forces; there are no data on battle deaths.
Illicit resources comprise resources siphoned off the other two flows, and additional resources from such things as land and natural resource sales, bribes paid to reduce tax and customs charges, and the informal economy of public service appointments. It is difficult to establish the volumes or drivers of illicit flows\textsuperscript{15} because an underlying motivation of such practices is to hide wealth accumulation from public scrutiny. But the dividends are evidently phenomenal. The Global Financial Integrity program – which tracks only cross border flows of illegal money – estimates that $850 million to $1 trillion in funds are involved annually, and around half comes out of developing and transitional economies (Kar and Cartwright-Smith 2008). Raymond Baker estimates that for every $1 of aid transferred, $10 in illicit money is transferred abroad (Baker 2005).\textsuperscript{16} The relative significance of illicit flows is most evident on a country basis. Based on interviews, estimates of annual losses to Cambodian government revenue through tax evasion, bribe-taking and diversion of resources amount to $300-500 million each year (Calavan, Briquets and O’Brien 2004; Nissen 2005; Transparency International 2006). This compares with $483 million in total development assistance and $550 million in domestic revenue in 2004, or approximately ten percent of GDP (IMF 2006).\textsuperscript{17}

That neither domestic nor illicit resources flows can be considered separately is made evident by the large literature arguing that strategic flows from donors can detrimentally affect, that is ‘crowd out’ incentives to improve domestic revenue performance, just as these flows can have ‘crowding out’ effects on the expenditure side (e.g., Gupta et al., 2003; Moss et al., 2006).

Table 3: Strategic Resources

<table>
<thead>
<tr>
<th>Country</th>
<th>Year conflict ceased</th>
<th>Strategic resources one year before as % of GDP</th>
<th>Strategic resources five years after as % of GDP</th>
<th>Strategic resources ten years after as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>1991</td>
<td>---</td>
<td>11.8</td>
<td>10.4</td>
</tr>
<tr>
<td>Guatemala</td>
<td>1988</td>
<td>3.4</td>
<td>1.9</td>
<td>1.2</td>
</tr>
<tr>
<td>Haiti</td>
<td>1994</td>
<td>7.3</td>
<td>6.2</td>
<td>7.2</td>
</tr>
<tr>
<td>Uganda</td>
<td>1986</td>
<td>5.1</td>
<td>20</td>
<td>11.1</td>
</tr>
<tr>
<td>Liberia</td>
<td>2004</td>
<td>9</td>
<td>94.7</td>
<td>---</td>
</tr>
<tr>
<td>Timor-Leste</td>
<td>2000</td>
<td>---</td>
<td>55.7</td>
<td>---</td>
</tr>
<tr>
<td>Solomon Islands</td>
<td>2003</td>
<td>8</td>
<td>46.3</td>
<td>---</td>
</tr>
<tr>
<td>Mozambique</td>
<td>1993</td>
<td>74.1</td>
<td>24.5</td>
<td>22.5</td>
</tr>
</tbody>
</table>

Source: WDR database codebook

Notes: See for Table 2.

Values indicated by "---" are not available.

There are however three features of strategic resource flows of relevance here. First, whilst fragile states typically receive significantly less aid than non-fragile states, in the aftermath of conflict, they receive on average more than non-fragile states, typically in a ‘surge’ (ranging from the bonanza at $350
per capita/year in Bosnia Herzegovina, to barely $30 per capita, Guatemala) which may or may not return to pre-conflict levels, but is likely to be sustained a higher than historical trend levels. Notably, this surge occurs when the capacity of formal systems are weakest, but when governing elites most need reliable ways of mobilizing finance and rapidly directing it to political constituencies. Second, strategic rents will tend to be allocated to non-economic sectors (social services) in ways geared to the achievement of medium term targets (as provided by MDGs, etc), and to short term security priorities, which typically have a limited effect on domestic revenue. Third, despite donor policy urging the harmonization and alignment of strategic flows, they will generally by-pass formal systems of public finance management and procurement. In other words, they will be managed through numerous parallel PFM systems which place a high premium on ex ante fiduciary controls, legibility and limited local discretion.

When these three resource flows are considered together, several things are striking. First, the formal systems of finance management and procurement will apply to only a part of total resource flows. This means that a significant share of political contest will occur outside of these formal systems. This will directly impact on how governing elites relate to formal systems and will impact negatively on the legitimacy of PFM systems, in the sense that this is derived from capacity of institutions to be credible sites for resolving competing interests. Second, to a considerable extent, the effectiveness of formal systems will be weakened by the diversion of administrative talent and energies by compelling incentives to ‘manage’ strategic and illicit resource flows. Third, with legitimacy and effectiveness weakened, formal systems will find it hard to marshal the ‘authoritative power’ to implement what the formal system requires. These points will tend to reinforce the ‘isomorphism’ we observed earlier in this section: formal PFM systems will in other words, tend to be most evident in their de jure dimensions, in the practices of core, central agencies, and in their ‘upstream’ dimensions.

The dual public sector and the case of procurement in the aftermath of conflict

The advent and character of the ‘dual public sector’ – one domestic, the other international – that results from the way strategic resource flows are managed is well documented (Hughes 2009, Ghani et al 2007, Boyce 2008, Leader and Colenso 2005, Craig and Porter 2006, Brinkerhoff and Goldsmith 2005). Duality in fact reflects a tension between domestic and international norms and priorities. The implications of this are particularly marked public procurement systems.

In conflicted settings, procurement systems can make or break efforts to establish the legitimacy of peace settlements and durably manage public expectations. Well functioning procurement systems bolster legitimacy in two ways, by what they do and how they do it. First, they enable governing elites to buy the peace by rapidly converting available resources into visible political goods. Procurement systems can enable governments to demobilize and reintegrate combatants and resettle displaced populations, mount cash transfer programs to service important political constituencies, and to enrol local businesses to rapidly create jobs through public works, or quickly rehabilitate road networks, refurbish and equip schools and health facilities. As important, good procurement systems make it possible to engage independent agencies to monitor leakage and demonstrate value for money. Thus
the credibility of government and the legitimacy they derive from meeting public expectations can hinge on the effectiveness of procurement systems.

Procurement systems can also buy legitimacy by how they operate. The resources needed to procure results largely depend on strategic flows. Domestic revenue is by contrast tied to non-discretionary commitments like paying the civil service wage bill, or feeding security forces. Thus, meeting expectations through procurement depends principally on working agreements between governments and donors. Experience shows the two are often at odds. Donors seek legitimacy in procurement by ensuring global procurement norms are observed. They tend to focus on ‘procedural’ norms of due process – complex and time consuming steps that pay special attention to the technical quality of contract documents, to level playing fields in international competitive bidding, and to sophisticated procedures for certifying progress and making payments to minimize their fiduciary risks. These features of procurement tend to have both short and long term consequences. Overzealous concern with the observance of de jure controls in the up-stream stages of procurement compromises the ability of states to expedite spending. A thicket of ex ante controls results in constipated procurement processes and transactional inefficiencies that can far outweigh the potential costs of corruption. Similarly, efforts to minimize discretion, coupled with international norms regarding fairness for international parties in bid processes can make it difficult to favor politically important domestic constituencies of suppliers and contractors. Thus, the ‘form’ of the procurement system can get in the way of the urgent need to achieve ‘functional outcomes’ in terms of both expediting spending and building local support. National elites indeed will seek both global and local sources of legitimacy but, short on technical knowledge of how to specify and administer what is needed in globally acceptable terms, will tend to adopt procedural short cuts or observe practices downstream – in certification, payments and reporting – which reinforce the isomorphism noted earlier. These practices draw the ire of their international partners concerned with fiduciary risk and corruption. And repeated resort to ‘fence breaking’ can mean these short cuts create precedents that undermine the long term legitimacy of government. To explain this point, we need to consider the medium term effects of the PFM systems typically used to manage different resource flows. We need also to restrict our illustration to a particular case.

**Medium term effects: strategic resources in a specific context**

What has occurred in Cambodia, more than two decades beyond violent conflict is of course unique, but not substantially so (elements of this can be found at various times in Afghanistan, Uganda, Pakistan, and West Bank Gaza, to name a few e.g., Snyder and Bhavnani 2005, Rakner et al 2004, van de Walle 2007, Fayyad 2010, Khan 2005). In Cambodia donors have been actively engaged in a much cited and innovative reforms in public finance management (Taliercio 2009). It has also been the place of much related experimentation over the past decade with sector wide approaches, contractualised service delivery, commune decentralization and erstwhile civil service reform. Over this period, several other PFM systems, many instituted well before the UNTAC engagement in 1992 (Gottsman 2003), have been elaborated by an apex group of the Cambodia People’s Party (Pak 2010). This has coupled administrative
recentralization with PFM systems for managing off-budget extraordinary rents from natural resources (minerals, land and forests) and a lucrative informal economy for civil service appointments (Eng and Craig 2008; Hughes 2008; Pak 2010). Although underway since the late 1980s, the government’s economic liberalization program has created windfall opportunities for Party-dominated speculative gains in urban property, commercial agricultural concessions and market regulation (Pak, et al., 2007; Pak and Craig, 2008). And, while still largely a black box to outsiders, since effectively coming to power in 1979, the CPP has consolidated control over national, province, and since 2000, commune politics and administration at all levels (Pak 2010). Table 4 illustrates the main features of the three PFM systems that developed to manage three flows of public resources in Cambodia.

Table 4: PFM systems for illicit, domestic and strategic resource flows: Cambodia example

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<thead>
<tr>
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<tbody>
<tr>
<td>Source of funds</td>
<td>Rents from NR, market access, property speculation, tithes on business, regulatory gate-keeping ‘ink money’ and fees from appointments, postings, transfers.</td>
<td>Formal, on-budget (customs, excise, fees, tax, tourism levies) revenue, but heavily pre-bendalised by party systems</td>
<td>Global compacts, multi- and bilateral agreements, trust funds, projects, programmatic/ sector financing</td>
</tr>
<tr>
<td>Purposes</td>
<td>Personal enrichment, loyalties, prestige, ceremony, virtue, regime durability. Extensive though very uneven funding (electoral cycles, business conditions). Off-shore transfers. Domestic spending mimics donor funding patterns – small infrastructure, facilities.</td>
<td>Establishment funding, low civil servant salaries, minimal non-salary recurrent, or capital Maintaining of establishment positions to superintend informal gatekeeping opportunities</td>
<td>Substantial though often uneven and unreliable, often requiring fund-specific governing arrangements. Focused on capital and non-salary recurrent, skewed to infrastructure and social sectors Fiduciarising executive funding flows (building “good governance”); audit, advisory, TA around this</td>
</tr>
<tr>
<td>Incentive systems &amp; ‘capability’</td>
<td>High levels of trust and local discretion. Low political contestability or transferability. High political accountability for delivery and quality. High capacity in NR and asset</td>
<td>High incentive for enactment of executive forms: compliance formality enables rents. Low levels of trust and formal capacity Low political accountability for delivery or responsiveness</td>
<td>Formalised accountabilities via contracting, salary incentives. Low political accountability (though some electoral dividend) for delivery via this system</td>
</tr>
</tbody>
</table>
13

<table>
<thead>
<tr>
<th>Low capability in regulatory and establishment control</th>
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<tbody>
<tr>
<td>High capability in natural asset regulation</td>
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<tr>
<td>Low capability and establishment control</td>
</tr>
<tr>
<td>Low formal political accountability.</td>
</tr>
</tbody>
</table>

Source: Craig and Porter 2011.

We suspect that Table 4 describes what occurs in many fragile contexts. Some features reflect ‘dualism’ – columns 2 and 3 – in which donors finance the bulk of capital investment and through contractualised arrangements, and a good share of non-salary recurrent spending in the social sectors. They are able to ‘incentivise’ through salary supplements the performance of the civil service, but only on a sporadic, sector or area basis, while the establishment is basically immune to external influence in how the formal system performs downstream in delivering services, regulating assets or enforcing rights. Operating alongside and deeply entwined with the formal PFM system (Col 2) is a well articulated and capable informal system (Col 1) that enjoys high levels of trust and discretion, is internally disciplined, but from the citizens’ viewpoint, has low political contestability. The system described in column 1 is able to mobilize significant revenues, control the regulation of natural assets (land, natural resources) on which livelihoods depend, and through patronage arrangements, the performance of the civil service establishment, the judiciary and security in all these respects.

An outlook on fragile state PFM systems that is informed by ‘dualism’ recommends a standard approach to ‘sequencing’ (OECD 2005). Where systems are chronically weak, parallel systems need to be installed, recognizing that these will exacerbate the problem, and that ‘transitions’ in the medium term will be made more difficult by the parallel systems installed. A vicious circle eventuates; chronic weaknesses in formal systems impel increasing donor engagement in direct social service delivery (albeit nuanced around country-owned SWAPs or programmatic approaches). Frustrated by the fact that actual downstream performance depends on a civil service they can only ‘treat’ by salary supplements, they ‘go around’ it by private sector contracting or augment it through technical assistance to install modern finance management systems in a project setting.

In a medium term perspective, appreciating that the existence of three-way, rather than dual, systems in fragile states suggests a quite different challenge for reforms in procurement and finance management, and for donor interventions in general. It requires perhaps less direct responsibility to deliver development outcomes –services on the ground – and greater attention to how to use expertise, influence and financing to alter the choices that governing elites make in relation to investing political capital, trust and expertise in the formal systems for managing finances and procurement.

Section 3: Over-coming gaps: Building durable medium term capabilities

Section 1 highlighted three axes of the disconnect between form and function. Section 2 speculated as to why this may be more pronounced in fragile situations and suggested that donors are embroiled in a three-part system through which ‘public’ finance management needs to be understood.
We have referred to aid flows as strategic resources not simply because they reflect diplomatic interests, nor because they are provided to assist countries to recover from conflict or exit from chronic fragility. Rather, these resources are ‘strategic’ because of the prospect they offer of reducing stresses and building capabilities in core state systems. But this prospect requires understanding the nature of the problem and the task in a particular way. Instead of gauging success only in terms of the adoption of upstream institutional forms – as we have described in Section 1 – imported by ‘analogy’ from somewhere else, the task is to use strategic resources in ways that influence the ‘rough and tumble’ (Doner et al., 2005, 329) of elite contest, to impact on elite incentives in ways that will drive positive changes in formal institutions. The challenge, in other words, is to find ways to use strategic resources to draw the capability, trust and resources that elites invest in informal systems into the formal system in ways that reduce stresses, and improves effectiveness and legitimacy.

Lest we are misunderstood, we are not arguing that PFM interventions jettison the ‘basics’, namely, the need to achieve aggregate fiscal discipline, the allocation of resources to priorities, or to get spending underway in accountable ways. Consistent with our PEFA disconnect findings, however, we are arguing that it is critically important to do this in ways that enhance the incentives for elites to invest political capital in achieving a) functional results through the formal PFM system, b) the effectiveness of agencies responsible for services and regulating activities, and c) better performance of civil service officials, whether at the service facility or local authority level.

With this preamble, what follows is a summary of actions we think could reduce stresses, build formal PFM system capabilities and reduce the disconnects we have observed in this paper. The theme running through all these suggestions is to use strategic resources in ways that add incentives for governing elites to act in ways that avoid the perverse effects of fragmented shadow systems, donor or informal, and sustain social contest in legitimate and effective formal systems. The first priority area focuses on the national scale, whereas the second is concerned with downstream outcomes.

1. **Reducing stress and increasing the prospect that domestic public finance and procurement systems will become credible instruments to sustain national social contest**

Under this area, we suggest three priorities.

*First, central to fostering political incentives to engage in core PFM processes is to reduce the perverse incentives through more concerted action on illicit resource flows*, in particular, trans-border flows through money laundering, corruption, criminal activities. Although regulation in this area has increased (post-9/11, post-GEC) and governments have been encouraged to tackle tax avoidance, corruption and evasion, global interdiction efforts must be a priority. There are already numerous systems; for diamonds (Kimberley process), extractive industries (Publish What You Pay, EITI, though principally for revenues, not upstream regulation), tropical forestry (The EU’s Forest Law Enforcement, Governance and Trade Action Plan) and so on (see McNiesh 2010). More is needed to extend their reach and effectiveness: EITI for instance has not yet delivered expected results because many of the ploys to
satisfy patronage clients are not monitored by EITI transparency. EITI++ was recently launched to address this issue, but it is too early to know the results of this revised approach (Benner et al, 2010).

Second, common accountability frameworks involving government and donor partners will more likely engage national elites in PFM reforms if linked with whole of budget financing. There are many variations in how policy, transitional or results frameworks can be used to create a mutual accountability of donors and governments in conflicted and fragile settings (most well known, in Afghanistan, Timor Leste, Sudan, Uganda, Mozambique, etc – covered in other WDR papers). But their effectiveness as devices to ‘claim attention’ is profoundly limited in two ways: that only a miniscule fraction of aid to fragile states flows through national finance and procurement systems; and by donor aversion to funding recurrent establishment costs. It is well understood that donor practices create perverse local incentives, as reflected in the ‘three way’ layers observed in Cambodia. Budget support ‘from the start’ is a contentious issue, fiduciary concerns are amplified and there are clearly cases where this is not sensible. But there are numerous ‘dual control’ arrangements that can be made within the context of a common accountability framework so as to exploit the known advantages of this, especially in relation to formal PFM systems (See AfDB, EC and World Bank 2009). And besides, the potential pay-off is that perhaps the most difficult part of achieving medium term capabilities (not least, in relation to the largest share of domestic public finance management) could become part of donor-government dialogue, namely, how the establishment functions and performs. At present, this core issue is either sidelined in special purpose CSR pay and remuneration projects – that have a poor record (World Bank 2008) – or, equally lamentably, is relegated to an ephemeral part of donor social service delivery projects that use parallel systems to incentivize front line performance.

Third, whole of government policy and financing relationships with fragile states will make for more productive dialogue on fragile state performance on the tax and regulation of social and economic life. While the ways that aid may undercut incentives for domestic taxation continues to be debated, it is clear that aid is seldom used strategically to improve revenue performance. Donors tend to reserve conditionality (by name or in effect) for expenditure side PFM performance and often neglect revenue performance. Whole of budget financing or Challenge grants might be used to incentivize elite decisions to bring more revenues into the budget process (Boyce and Foreman 2010; Brainard 2003). But this might offer a more important prospect. Deft leveraging of aid flows against revenue performance would present opportunities to bring into public debate the horizontal and vertical equity and distributional consequences of the way fragile governments regulate assets of prime importance to the poor, including natural/land assets and the conditions of market entry for livelihoods.

2. Improving central-local linkages, achieving territorial and population coverage through a focus on downstream results

There are several well known ways of achieving better downstream results by deconcentrated actors. These include community driven and participatory development approaches, sector-wide approaches, the contractualising of services and priority actions programs (as covered by other WDR thematic
papers). These solutions are always context specific and can at times have perverse outcomes for peace, security, the effectiveness of service delivery and, not least on the coherence and credibility of PFM systems (for examples of the range, Brick 2008, Cliffe and Manning 2008, Dasgupta and Beard 2007, Barron et al 2009). In PFM terms, we believe many of these unintended outcomes would be less likely to occur if these interventions occurred in contexts where the actions identified above were being undertaken in tandem. Here we argue that three other sets of actions could reinforce these measures and create further incentives for downstream results.

First, in many fragile settings, resource sharing agreements between central and sub-national authorities linked to performance can build greater accountability, local confidence and achievement of functional results. While various forms of decentralization have been amongst the most popular reforms to improve public sector efficiency, responsiveness and accountability, there is no general consensus on how decentralization eases or exacerbates conflict.\textsuperscript{19} Multi-country statistical analysis however concludes that decentralization can mitigate conflict where it successfully brings subnational groups into a bargaining process with government, signals to weaker parties that government is willing to compromise and accommodate, builds trust and increases state legitimation and is perceived to equitably share resources amongst regions in ways that reduces unevenness (Seigle and O’Mahony 2008). The recent achievements of Pakistan (see Box 1) to conclude the fiscal sharing agreement between the federal government and four province governments show that overcoming historically difficult inter-governmental issues can build confidence and trust.

PFM systems can be a determining factor in whether these national-local agreements amount to improved political legitimacy or effective service delivery. Decentralization is of course not a zero sum game (decentralization versus centralization). Where it works best, it reflects strengthened ties between concentrated and deconcentrated agencies. When linked with authentic political decentralization, and where the focus is on enhancing the volume and local control over expenditures (relative to revenue collection), fiscal decentralisation is linked to improved government responsiveness to local priorities and a lower probability of ethnic conflict (Seigle and O’Mahony 2008, 54).

While the early flush of expectation has dimmed and the results are much debated (cf. Green 2008, Treisman 2007 and Ssewankambo, Steffensen and Tidemand, 2008), Uganda’s decentralization, regarded as “one of the most far-reaching local government reform programs in the developing world” (Francis and James 2003, 325), we think persuasively illustrates our point that PFM reforms arise from the needs expressed through elite contest, and the use of donor strategic resources to work with this accommodation and subsequently institutionalize more robust relations between central and deconcentrated local actors. The process has dramatically impacted on the quality and intensity of debate around the politics and legitimacy of central-local relations, relations between elected and administrative officials, and accountability for how money is raised and used, services are delivered, land and other disputes are settled. This is not surprising, given that the central government transfers in the order of 25-30 percent of national revenues to local authorities through a range of block, conditional and equalization grants. PFM systems, hybridizing local and international practices and creating incentives for compliance with national regulations, policy commitments, PFM procedures and
requirements on good governance, as partly explained in Box 2, have been crucial in this process. But these innovative PFM systems, whereby the grant system is used to incentivise performance in core areas of local government functioning, could be adopted only once the ‘contemporary necessity’ (Uganda Constitutional Commission 1993) had been widely accepted – that is, driven by the popular appeal of empowering people on the peripheries of the nation’s geography and politics, whilst also consolidating the authority and legitimacy of the governing regime. The experiences from linking the access and the size of the grants against the performance in areas such as planning, PFM and transparency, has had a positive impact even under difficult circumstances.

**Second, public procurement can provide a far-reaching platform for constructive engagements among formal structures, local elites, and donors around the delivery of services.** In fragile and conflict environments, state decisions relating to what to purchase, from whom, and for whom are intensely political. Procurement rules and processes can have far-reaching implications for the shape of elite interactions, the ability of the government to deliver services, and the nature of accountability. While default procurement and financial management arrangements reveal a strong donor inclination for orthodox forms, governing elites are often hostile to approaches focused on mandating compliance to “best practice” procedures. A coherent approach to public procurement in fragile environments is likely to include measures to increase the speed of procurement as well as efforts to enhance the capacity of the government to procure needed items, efforts to shape purchasing strategies around an understanding of relevant political and economic markets, and steps to enhance monitoring and oversight of delivery and maintenance of procured assets through hybrid forms of accountability (linking formal and non-traditional mechanisms). Useful strategies are also likely to include a sequenced approach to establishing systems that produce value – with arrangements that may be necessary at the end of conflict (including reliance on a third party to undertake procurement or the use of indefinite quantity contracts) transitioning to interim mechanisms (centers that vest responsibility for procurement with local officials assisted by international experts or the use of contracts with capacity-building set-asides) before moving to more standard procurement arrangements.

These new directions feature short-term reliance on external procurement expertise structured so as to build indigenous capacity, operative rules that explicitly support the development of local markets, and enhanced oversight of contract performance through mobilization of beneficiary communities and others. Examples include the following:

- Greater use of international agency implementation, at Government’s request, combined with specialized procurement units in multilaterals or special purpose procurement centers to provide this service;
- Non-competitive arrangements for contracting of third country south-south assistance (such as twinning arrangements), within agreed limitations;
- More frequent use of variable quantities contracting, where tenders are let at regular intervals with a range of specified quantities of works, goods or services; and country programs can draw down on these tenders in given emergencies;
• Simplification of contractual processes and forms (especially in procurement at local levels) and explicit consideration of local capacities throughout the procurement process (e.g., use of local languages in tender documentation, contract sizes adapted to encourage local participation); 24
• Inclusion of contractual requirements to support current and future employment opportunities; 25
• Specialized financial management staffing for emergencies, with knowledge of reasonable documentation in initial periods in low capacity countries.

Third positive experience with PFM reforms in fragile situations underscores the need for more attention to leadership, coalition building and change management. Recent work, as illustrated by Palestine’s experience (see Box 4), shows that when institutions change in development, it is often because of strong leadership by groups of leaders working in coalitions (Andrews, McConnell and Wescott 2010; Leftwich et al. 2009). This research indicates that leadership—or institutional entrepreneurship—can help to build the space needed for change to take place. This space manifests where acceptance of change is supported by authority to change and ability required for devising and implementing new institutions and ideas.

This space must be present for conceptualizing, initiating, implementing and finally institutionalizing change—different stages which may be sequential and may not, could take one day or five years, and are vulnerable to interruption and negation in fragile contexts. The emphasis on leadership through groups and coalitions is a vital one in fragile settings where donors often work with individual champions. Groups include people with multiple functions, not just one or two talents, have multiple sets of connections, not just one, and can thus support more far reaching and influential institutional changes. Groups also carry change conversations within them, allowing new ideas to emerge from ongoing dialog and engagement without being unduly threatened by external forces. Interestingly, the research finds that these groups are often comprised of elites, who are led to consider new institutional forms despite their own embeddedness in prevailing institutional structures. These elites question prevailing structures often because of pressing problems they perceive to threaten their well being—which could be socially devastating diseases like HIV or rampant service delivery problems that undermine civic authority structures, or just the influence of economic growth on social structures dependent on low growth equilibriums.

We believe the failure to engage with leadership groups is a major factor behind the deconcentrated gap discussed in this article. Evidence from countries like Mozambique (see Box 5) shows that PFM reform progress happens where groups are engaged in dialog about such reform. But this dialog is often extremely limited and does not involve those who actually implement reform. Why are we surprised when the implementers actually fail to institutionalize reforms? Communities of practice and other broader network structures can be effective in building broad leadership coalitions around key PFM problems—how to pay bills on time or allocate enough money to basic services, perhaps.
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Box 1: Pakistan National Finance Award

After four months of hard bargaining, the Seventh National Finance Commission Award was signed during December 2009 by finance ministers from Pakistan’s four provinces and the federal government. Given the lingering disagreements on sharing of the nation’s fiscal resources, it was hailed in the media as a “major achievement and a positive event for those who believe that the future of a vibrant Pakistan lies in a democratic federation”. The consensus could not have been achieved without the rare display of mutual understanding, accommodation and magnanimity. As part of the Award, the federal government sacrificed part of its share of the national divisible pool of resources in favor of the provinces. While all provinces will receive an increase in resources, three provinces accepted a reduction in their shares, so as to provide more resources to Balochistan. Balochistan has been guaranteed a minimum award, with the centre pledging to make up for any shortfall, while in a nod towards the NWFP’s extraordinary burden in the war against militancy, the province has been promised a special one per cent of the undivided federal pool. There had been growing disillusionment with the Federation, and anger against Punjab for resisting any criteria other than population for distribution of resources since 1973. In Balochistan, there was the beginnings of an active secessionist movement. Punjab and Sindh have always been at loggerheads over distribution of water and have failed for the past 30 years to agree on any new developments because of a total lack of trust. The NFC decision was labeled by the Federal Finance Minister Shaukat Tarin as “the first step towards financial autonomy of the provinces and a victory of democracy”. NWFP Chief Minister Ameer Haider Hoti remarked that the Award “laid the foundation for strengthening the provinces”. Under the new Award, the federation has moved away from the unsatisfactory single criterion of population to a multi-criteria award that includes poverty/backwardness, revenue collection and generation, and inverse population density. At a time when defense and security-related expenditures are rising, the Award has important implications for the federal government. To achieve budget deficit targets in the range of 2.5 to 3% of GDP agreed with the IMF, it would need to increase its revenue collection from 8.8 per cent to 13.9 per cent and cut its expenses from 14.1 per cent to 12.5 per cent by 2014-15.

The NFC is but one instrument the federal government has employed in its attempts at assuaging Balochistan. The second and also very important instrument is a set of actions called the Balochistan package (named Aghaz-e-Huqooqe Balochistan or the Commencement of Rights of Balochistan), unveiled a few weeks before the NFC. The package comprises constitutional, political and budgetary measures. Some of them are: immediate release of political prisoners, expeditious recovery of missing persons, judicial inquiry by the superior judiciary into the murder of Baloch leaders, rationalization of royalty on natural resources, rationalization of federal excise duties, restructuring of laws on civil armed forces in the province, constitution of the new NFC award keeping the size, revenue generation and poverty in mind, removal of check-posts from the province as demanded by the provincial assembly and withdrawal of forces from Sui, the main gas mining area, and other parts of the province. The federal government has also agreed to NWFP’s long-standing demand for settling arrears of hydro-electricity royalty that Water and Power Development Authority, the federal utility company, owes to the province but has never paid. The arrears amount to more than two times the size of the provincial budget.
Box 2: Performance Grants in Uganda.

Uganda was an early innovator with performance based grant systems (PBGS). Having been introduced a decade ago, it has become a key part of the country’s central-local government system (Porter and Onyach-Olaa 1999) and now features in at least 15 countries (Steffensen 2010). While there are now many variants (see Rwanda Health P4P box) all PBGS introduce two kinds of conditions on how sub-national authorities access central government fiscal transfers. They require compliance with de jure ‘authority instruments’ on PFM and fiduciary safeguards; but they go one step further. They provide more or less funds depending on how resources are used; in other words, PBGS systems explicitly aim to impact on the incentives facing political leaders and administrative officials. These incentives may target revenue collection, the quality of planning and budgeting, the local authority’s performance on accountability ‘upwards’ (to policies in Uganda’s Poverty Eradication Action Plan), or ‘downwards’ (the quality of citizen participation, public disclosure), and ‘horizontally’, to impact on the relations between political and administrative officials. An 80% score on all these indicators results in an addition of 20% in the amount of the grant; less than 80% in any of the indicators yields a corresponding reduction. While the amount of money initially transferred to Uganda’s local governments was modest (around $1.5-2 per person/year) and predominantly only for donor funds, the impact on performance encouraged the government which is now planning to apply it to the Program for Modernization of Agriculture (PMA) and National Agriculture and Advisory Services (NAADS) to local authorities. This, including the Local Development Grant which is a block PBG now fully funded by Government, could by some estimates bring PBG transfers from central government to LGs around 40% of national resources (Government of Uganda 2009). Thus, the performance grant system has helped, in a modest way, breathe life into politics, from central to very local, by augmenting the incentives to invest in regularized systems for contest around how resources are allocated and used.

Box 3: Rwanda’s Pay for Performance Program.

An impact evaluation of an experimental maternal and child health program in Rwanda shows significant, verifiable improvements in health worker performance following introduction of the ‘Pay for Performance Program’. In 2005, Rwanda decided to supplement its primary health care services with a “cash for performance” program that would improve health worker morale and productivity and deliver better quality services for the country’s mothers and children. Using 14 maternal and child healthcare output indicators, the government committed to reward clinics and facilities which provided services to the satisfaction of patients with a series of bonus cash payments. If, for example, the facility meets all of the government’s quality criteria, then it receives an index score of one and receives full payment for the services. However, if the facility is deficient in some of the quality criteria, then all of the payments are discounted. For example, if the facility only scores 0.80 on the quality index, then it only receives 80 percent of the payment for the P4P services. Patient follow-up surveys and polling are the key determinants of whether the services were considered satisfactory or not. The evaluation studied 166 of Rwanda’s 401 primary care facilities over a 24 month period and backed up these findings with random samples of 13 households living in the local areas served by the clinics. By offering the clinics the equivalent of $1.83 for women who were new contraceptive users, $4.59 for each mother who delivered her baby safely on their premises with skilled midwives, $1.83 for each referral of a malnourished child for treatment (almost 50 percent of children in Rwanda are stunted), and 92 cents for every child who completed vaccinations on time, the P4P program achieved significantly increased use and quality of a number of critical maternal and child health services.

Sources: drawn from
In June 2002, the Israeli Army had just concluded a major military operation in West Bank, and unemployment and poverty were sharply rising. Audits revealed serious violations of finance management regulations. Off-budget contingency funds were utilized to maintain patronage networks and to buy internal political loyalties. And yet, the leadership was concerned that its financial vulnerability—Israel controlled nearly 60% of the Palestinian Authority’s (PA) revenues, and donors financed virtually the entire capital budget—would be used to extract political concessions. PFM reforms would risk diminishing fiscal flexibility, so strong incentives existed to maintain independent, off-budget sources of revenue for discretionary purposes.

The issue came to a head as Israel increasingly withheld revenues, and donors withheld budget support. Arrears built up with the private sector, and monthly salary payments for public sector workers were delayed. In the face of widespread support for reform across the political spectrum, President Arafat appointed a new Cabinet including Salam Fayyad as Minister of Finance, formerly with the World Bank and, until 2001, the IMF’s Resident Representative in West Bank Gaza. An Inter-ministerial Reform Committee gave high-level support and coordination to the reform agenda, augmented by an International Task Force bringing in donors, and a National Reform Committee with broad-based Palestinian representation.

Minister Fayyad took an opportunistic approach, focusing on reform areas he could control. For example, he found that ministries retained their own revenue, and used it to cover expenditures beyond budgetary appropriations. To address this, he issued a circular instructing banks that all government funds should feed to a single Treasury account, and that any checks issued directly by line ministries should be blocked. In another example, the Palestine Investment Fund was given a formal legal structure, and all PA assets were evaluated in a transparent manner. This helped to curb the use of off-budget accounts in handling PA assets.

To address the problem of writing checks with insufficient funds to clear them, the Minister instructed the person who sends the check to the bank to hold them all until the end of the day, and then only send checks up to the amount of funds available. To address predatory practices by the Petroleum Commission, the Minister froze their accounts, audited them, and changed the management and governance structure. To address corruption in salary payments to security personnel, he got their names (previously not disclosed) and substituted bank transfers for cash payments. When staff were unwilling to comply with these or other reforms, the Minister redirected workflow around them.

As a result of the reforms, Israel agreed to restart transfer of revenues to the PA, and international assistance nearly doubled. There was also strong domestic support for the reforms, seen as important building blocks in the broader struggle for national liberation and statehood. While there remain many challenges, the PFM reforms rank among the most far-reaching and successful in the broader Middle East and North Africa region.


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**Box 5: Communities of Practice: Mozambique**

The Mozambican situation is very interesting for fragile countries to view. The country is nearly twenty years removed from conflict, and in that time it has grown significantly and established solid governance and PFM systems. However, the form of these systems is still stronger than the function—with strong laws and systems that are still being implemented. The de jure gap is related to a concentration problem, where very few technical people in Maputo are actively engaged in reform dialog and others enjoy extremely limited engagement. Fig. 4 shows how very few agents considered important for reform actually engage regularly in discussions about why
and what will be in reform—those engaging are shown in red, orange, yellow, green and blue. Most agents do not engage at all—the vast selection of deconcentrated and disconnected pink circles.

Box 5 cont’d

Fig 4. Concentrated reform conversations

Fig 5. Deconcentrating reform conversations through communities of practice

Note: Pink circles show poorly connected entities; Blue circles show entities connected with low scores of 10 to 15; Green shows entities connected to others with an intensity of 15 to 20 (also low); Yellow score entities have connections of intensity 20 to 30 (still low, but getting stronger); orange score entities have connections of 50 to 75 intensity (quite high); red entities are the main communications entities; Donors are the red set of triangles.

In an experimental meeting with some of these deconcentrated agents, researchers found they have much to say about the functionality of new laws, systems and reforms and this feedback could be vital in shaping solutions that are effective in both form and function (Andrews, Grinstead, Nuñofora and Seligmann 2010). In response to such experiment, the government is considering developing communities of practice and other networking mechanisms around continuing problems—in strategic budgeting and internal audit for example—to expand the dialog around what the problems really involve and what local solutions might look like. A simple once-a-month community of practice engagement between concentrated budget entities and central, provincial and district representatives from education and health sectors will expand dialog significantly, reflected in the adjusted network Figure 5. Communities of practice like this can change the discussion from one centered on form to one centered on function, help to make reform limits apparent early one, and engage commitment and group-based leadership needed for reform implementation.
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**Annexures:**

**Annex 1. The 64 PEFA PFM Process Dimensions**

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PI-17iii Systems for contracting loans and issuance of guarantees

PI-18i Degree of integration and reconciliation between personnel records and payroll data

PI-18ii Timeliness of changes to personnel records and the payroll

PI-18iii Internal controls of changes to personnel records and the payroll

PI-18iv Existence of payroll audits to identify control weaknesses and/or ghost workers

PI-19i Evidence on the use of open competition for award of contracts

PI-19ii Extent of justification for use of less competitive procurement methods

PI-19iii Existence and operation of a procurement complaints mechanism

PI-20i Effectiveness of expenditure commitment controls

PI-20ii Comprehensiveness, relevance and understanding of other internal control rules/ procedures

PI-20iii Degree of compliance with rules for processing and recording transactions

PI-21i Coverage and quality of the internal audit function

PI-21ii Frequency and distribution of reports

PI-21iii Extent of management response to internal audit findings

PI-22i Regularity of bank reconciliations

PI-22ii Regularity of reconciliation and clearance of suspense accounts and advances

PI-23 Availability of information on resources received by service delivery units

PI-24i Scope of in-year reports in terms of coverage and compatibility with budget estimates

PI-24ii Timeliness of the issue of in-year reports

PI-24iii Quality of information in in-year reports

PI-25i Completeness of the financial statements
PI-25ii  Timeliness of submission of the financial statements
PI-25iii  Accounting standards used
PI-26  Scope/nature of audit performed (incl. adherence to auditing standards)
PI-26i  Timeliness of submission of audit reports to legislature
PI-26ii  Evidence of follow up on audit recommendations
PI-27i  Scope of the legislature’s scrutiny
PI-27ii  Extent to which the legislature’s procedures are well-established and respected
PI-27iii  Adequacy of time for the legislature to provide a response to budget proposals
PI-27iv  Rules for in-year amendments to the budget without ex-ante approval by the legislature
PI-28i  Timeliness of examination of audit reports by the legislature (for reports received within the last three years)
PI-28ii  Extent of hearings on key findings undertaken by the legislature
PI-28iii  Issuance of recommended actions by the legislature and implementation by the executive

Annex 2. PEFA analysis: list of countries
Afghanistan, Albania, Armenia, Azerbaijan, Barbados, Bangladesh, Belarus, Belize, Benin, Bolivia, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Colombia, Comoros, Congo, Dem. Republic of, Congo, Republic of, Cote d’Ivoire, Dominica, Dominican Republic, Egypt, El Salvador, Ethiopia, Fiji Islands, Gabon, Gambia, Georgia, Ghana, Guinea, Guinea Bissau, Grenada, Guyana, Haiti, Honduras, Indonesia, Iraq, Jamaica, Jordan, Kazakhstan, Kenya, Kosovo, Kyrgyz Republic, Lao PDR, Lesotho, Liberia, FYR Macedonia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mauritius, Moldova, Montenegro, Morocco, Mozambique, Namibia, Nepal, Niger, Norway, Nicaragua, Pakistan, Papua New Guinea, Paraguay, Peru, Philippines, Russian Federation, Rwanda, Sao Tome and Principe, Senegal, Serbia, Seychelles, Sierra Leone, Solomon Islands, South Africa, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Sudan, Swaziland, Syria, Tajikistan, Tanzania, Thailand, Timor Leste, Tonga, Togo, Trinidad and Tobago, Turkey, Tuvalu, Uganda, Ukraine, Vanuatu, West Bank and Gaza, Yemen, Zambia.

2 Notably, the macro-economic, financing, natural resources and anti-corruption papers.
3 A similar, standardized diagnostic tool exists specifically for procurement as a result of the OEDC Declaration of 2006, See OECD/DAC Benchmarking and Assessment Methodology for Public Procurement Systems.
4 Nine additional dimensions relate to outcomes and donor practices.
5 PEFA does not allow a full analysis of ‘downstream’ performance since the indicator set focuses on revenues and expenditures undertaken through the central government budget.
6 De facto and de jure dimensions were identified through a process where three coders identified dimensions in which a country could not score a C or better without de facto change in day-to-day practices. 38 Dimensions were so coded, with 26 as
de jure, with an inter-coder reliability of 0.889 (calculated using Fleiss’ kappa and Krippendorff’s alpha). Dimension 19(i) is an example of a de facto dimension, as a country can only score a C if it provides actual data about actual procurement activities, particularly indicating the value of contracts awarded on a competitive basis. Dimension 19(iii) is an example of a de jure dimension, where a country moves from a D to a C simply by creating a process to submit and address procurement complaints, even if “it is designed poorly and does not operate” effectively.

7 Concentrated agent dimensions were identified as those falling under direct control of agents in core PFM agencies including Central Treasury, Budget Office, Debt Agency, and others. Three coders identified 28 dimensions, with an inter-coder reliability of 0.978 (calculated using Fleiss’ kappa and Krippendorff’s alpha).

8 16 Upstream dimensions were identified by asking which PEFA dimensions relate to parts of the PFM system involving planning, budget preparation and legislative analysis of the budget documents, or the structure of these documents (upstream). 48 downstream dimensions were identified, referring to PFM execution areas including cash management, procurement, internal control and audit, monitoring and reporting and external audit.

9 De Renzio describes a similar finding: “Average scores tend to deteriorate the further one moves down the various phases of the budget cycle, from formulation to execution, reporting and scrutiny.” (de Renzio 2008, 6). Similar patterns have been observed with procurement reforms (Brookings Institution & Sanchez 2009).

10 The quality of data did not allow us to do this for all 101 countries. We cleaned the data for these 31 countries, validating scores against both PEFA criteria and written descriptions in country Public Financial Management Performance Reports. We also used the Performance Reports to gather qualitative data about the differences between fragile and non-fragile countries.

11 In all of these areas every single dimension is more than 0.75 points weaker in fragile countries, and in all cases these differences are statistically significant (at 0.05 or better).

12 We took a sample of 20 fragile and conflict affected states with a CPIA score of 2.5 or less for 2008, and a representative sample of seven others with higher scores. Overall, where the World Bank has made investments PFM projects since 1999, improvements have occurred in the quality of budget and financial management. Out of 10 sample countries where the Bank provided PFMP assistance between 1999 - 2006: 8 showed an improvement by 2008 in PFMP performance based on the CPIA 13, one showed no change, and one showed a deterioration. By contrast, for the 10 countries where the Bank did not provide PFMP assistance during the same period, only one showed improvement, four showed no change, and five showed a deterioration.

13 While this touches on matters developed in other WDR Background Papers (notably, the Institutions, Financing, NR and Anticorruption papers), it is important here to sum their key attributes – for these underpin several of the conclusions we draw about PFMP in fragile/conflicted settings as well as measures that might ease these stresses and build capabilities.

14 Data on missing years has been requested from IMF.

15 For instance, the degree to which macro-economic mismanagement reduces returns on domestic investment relative to foreign prospects, or the perceived risks of exchange rate depreciation, tax avoidance, under-remuneration civil service employment, etc.

16 ‘Illegal capital flight’ refers to resource flows that are intended to disappear from any record in the country of origin, and earnings that do not normally return to the country of origin.

17 Some illicit flows come from development assistance or domestic revenue (e.g. kickbacks on procurement contracts), and some are come from outside these sources (e.g. illicit sales of public land and natural resources).

18 Over 60% of respondents in a recent survey said that the Bank’s procurement procedures were not adapted or only slightly adapted to fragile contexts (World Bank 2006: 55-6, 150.). It takes a minimum of four iterations between a government and the World Bank before signing any contract subject to international competitive bidding (and two iterations for a contract subject to national competitive bidding processes. These numbers can and often do rise in countries with limited procurement capacity due to repeated problems in the form and substance of tender documents, tender procedures, evaluations of proposals, and complaints. While it is possible for a relatively simple ICB tender to be concluded in under six months, the time it takes for procurement is much longer. Limited data from one relatively well performing country reveals an average processing time of over 250 days for ICB contracts, a figure well short of the over 370 days that it took to process procurements in a country with much significantly less expertise. Procurement of consultants is often particularly problematic – research undertaken in the past five years suggested that the average length of procuring a consultant for a World Bank supported project exceeds the length of the consultancy.

19 Seigle and O’Mahoney (2008) survey a wide range of claims that decentralized systems can contribute to social and political stability, including as part of conflict avoidance and post-conflict reconstruction (Lake and Rothchild 2001). The type of decentralization, the particular social context and conflict experience all impact (Bardhan 2002, 2005) or weakens incentives to invest in national public goods and priorities, thus generating new tensions (Diprose and Ukiwo 2008).
These systems of performance-based allocations has since been applied in an increasing number of countries, e.g. Steffensen (2010).

The UN Office of Project Services has considerable experience in post-conflict resettlement activities, where dual controls are used to assign some procurement decisions to counterparts – what shall be procured and for what purpose – while retaining executive control over bid evaluation and delivery. This has been a successful feature of several emergency responses, including UNTAC’s rapid response to resettling returning refugees in Cambodia’s northwestern provinces in 1992/93.

The Indian state of Tamil Nadu, for example, has entrusted the Tamil Nadu Corporation – a single purpose state company – with responsibility for purchasing pharmaceuticals and other medical supplies. This arrangement has worked so well that the Corporation is in great demand by other Indian states looking to contract with it for the provision of similar services. Timor Leste has had a positive experience with designating one center within the Ministry of Education to execute all procurement relating to school construction. These arrangements have enabled a level of school construction which far outstrips the ability of the government to deliver on other infrastructure objectives. The Government of Pakistan is exploring the creation of a corporation jointly owned by the government and donors which will undertake procurement activities to respond to the recent floods.

Indefinite Quantity Contracts are used by several bilateral agencies – such as USAID – to reduce the need for repeated tenders for common goods and services. Other countries, such as South Korea, have used Framework Contracts – instruments that enable state purchasing from multiple suppliers provided the supplier is able to meet cost and quality specifications for a particular good – to reduce the frequency of competitive tenders at the same time that they increase the number of potential suppliers.

Procurement systems are at the heart of providing opportunities for elites to stabilize political settlements, or to build wider coalitions of support. Procurement systems that focus excessively on speed or minimizing fiduciary risk tend to exclude local firms. Significant economic and political opportunities can be lost. See Carnahan et al 2006; Durch 2009; Shaping purchasing decisions and procurement processes to encourage participation of key constituencies can be pursued in a number of ways and can increase the “value for money” of procurement spending. For example, Simplified contracting processes are a familiar feature of projects focused on supporting community-driven development. World Bank procurement policy for community level contracting has simplified procedures for contract formation and greater reliance on community oversight to ensure performance.

Emphasis on labor intensive construction methods in Nepal in the early 1970s has been credited with playing a formative role in the development of the domestic Nepal construction sector.