Key Issues

1. Effective financial management of public resources is essential to achieve the objectives of development programmes. It also promotes accountability within developing countries and provides donors with assurance on the use of their funds. Good financial management systems in partner countries are required for all forms of aid, but are particularly important for budget support, where donor funds are not allocated to finance specific expenditures. Diagnostic reviews in public financial management are a growing source of information to both governments and donors. They reflect the state of public financial management systems, the risks and constraints that these pose to the implementation of development programmes and the use of donor resources (See Box 1). Diagnostic reviews and performance measures assist governments in creating strategies that improve management of public finances.

2. Diagnostic reviews provide information on the strengths and weaknesses of the public financial management systems of partner countries. They support country efforts to improve the performance of their public financial management systems, and so contribute to improved development outcomes. They also provide information to allow donors to consider the risks that their funds may not be used for agreed or appropriate purposes. Thus, partner country governments and donors have a shared interest in high quality diagnostic reviews.

3. In recent years, the proportion of development funds made available through government financial systems has increased significantly. Efforts by donors to improve their understanding of the functioning of these systems have brought about the risk of an uncoordinated development of different diagnostic reviews. For developing countries, this means that a disproportionate amount of scarce administrative resources may be spent fulfilling multiple donor requirements. For development agencies, it may lead to unnecessary duplication of work. Thus there is considerable value, for donors and partner countries alike, in harmonising different diagnostic reviews and placing them in the context of a coherent, sequenced programme of work to strengthen public financial management. This, in turn, should be an integral part of participating donors’ strategies for country assistance and the country’s own poverty reduction strategy.
A diagnostic review examines a partner country’s public financial management system and practices. Diagnostic reviews are generally not audits and do not track individual items of expenditure. Nor do they provide a pass or fail assessment of a country’s public financial management system in terms of its adequacy for managing external funds. Rather, they provide donors and governments with information on:

- The strengths and weaknesses of public financial management systems.
- The risks to which funds channelled through governments’ systems may be exposed.
- The government programmes aimed at improving these systems.

4. Diagnostic work records the state of public financial management at a point in time. Partner countries and donors have a shared interest in being able to monitor progress over time in improving public financial management systems. A performance measurement framework — and an associated set of reform measures — assists them in this by building on the information set out in diagnostic reviews.

5. Much of the formal diagnostic work in the area of public financial management is still evolving. A number of diagnostic tools are used. The main instruments with a brief description of their purpose are listed in **Box 2**. In addition to these formal reviews, important diagnostic work is often carried out through specific technical assistance projects or as part of the preparation and implementation of donor financed activities.

**Box 2: Current diagnostic tools**

- **Country Financial Accountability Assessment (World Bank)** — CFAAs are a diagnostic tool designed to enhance knowledge of public financial management and accountability arrangements in client countries.

- **Public Expenditure Review (World Bank)** — PERs analyse the recipient country’s fiscal position, its expenditure policies – in particular the extent to which they are pro-poor – and its public expenditure management systems.

- **Country Procurement Assessment Review (World Bank)** — CPARs examine public procurement institutions and practices in borrower countries.

- **HIPC Expenditure Tracking Assessment (World Bank & IMF)** — These assess the ability of the public financial management systems in highly indebted poor countries (HIPCs) to track poverty-reducing expenditures, using fifteen public financial management benchmarks.

- **Fiscal Transparency Review (IMF)** — This is a module of the Reports on Observance of Standards and Codes (ROSC) which uses the Code of Good Practices on Fiscal Transparency adopted by the IMF in 1998.

- **Diagnostic Study of Accounting and Auditing (Asian Development Bank)** — These examine financial management and governance practices in the public and private sectors of borrower countries.

- **Ex ante assessment of country financial management (European Commission)** — Traditionally, the EC has carried out audits of its “targeted” budgetary support with a view to determining expenditures “eligible” or “ineligible”. For future budget support, however, it is developing a new approach using ex ante PFM assessments based on a mix of diagnostic work completed by other donors/governments and a “compliance test” to provide an empirical evidence of performance of the PFM systems.

- **Country Assessment in Accountability and Transparency (UNDP)** — CONTACT is a toolkit to assist governments and consultants in conducting missions to assess public financial accountability systems.
Purpose

6. The purpose of this paper is to put forward a set of good practices on how donors and governments can collaborate to make diagnostic reviews and measurement of performance in public financial management more effective. In pursuing this goal it seeks to achieve four specific objectives:

- **Maximise developmental benefits** — Diagnostic reviews are a valuable input to government efforts to improve public financial management systems. Their quality and impact can be improved by encouraging stronger country ownership and in-country consultation, and by integrating the reviews into both government and donor decision-making cycles, programmes of country assistance and poverty reduction strategies.

- **Make information more readily available** — Sharing the information and knowledge they provide with both donors and partner governments enhances the impact of diagnostic reviews.

- **Rationalise diagnostic reviews** — Diagnostic reviews should provide full coverage of public financial management issues without unnecessary duplication. Donors should reduce the burden on developing countries through fewer and better co-ordinated diagnostic reviews.

- **Provide a framework for performance measurement in public financial management** — Partner countries and donors have a shared interest in being able to monitor progress over time in improving public financial management systems, as reflected in diagnostic reviews. This paper provides broad guidance on how donors might address this emerging issue in individual partner countries.

7. The practices set out in this paper are consistent with those described in the Good Practice Paper entitled *Country Analytic Work and Preparation of Projects and Programmes*.

Guiding Principles

Diagnostic work

8. The following principles guide the elaboration of good practices in diagnostic work in this paper:

- **Partner country governments should be fully involved in and have ownership of diagnostic reviews** — There is scope for partner governments to be increasingly involved in the conduct of diagnostic reviews and this paper suggests a number of good practices to that end. This should improve the quality of these reviews and provide greater incentives for donors and partner governments to strengthen public financial management systems.

- **Harmonised diagnostic reviews alleviate the burden on partner countries** — Donors should rationalise the scope, timing and conduct of diagnostic reviews so as to avoid unnecessary duplication of work, and should rely as far as possible on other donors’ diagnostic reviews to satisfy their requirements.

- **Harmonisation does not mean standardisation** — In many countries receiving development assistance, public financial management systems may fall well below international good practices. This does not mean that financial assistance should not be provided to these countries: each donor must decide what level of risk it accepts in providing funds through the partner country’s budget, in relation to developmental benefits. Thus, different donors may make different decisions on the basis of the same diagnostic review.
Diagnostic reviews should be responsive to country development context — Improvement in public financial management systems is part of the overall development agenda, driven by the partner country and supported by donors. Undertaking of diagnostic work will be influenced by and feed into the overall country support strategies. Diagnostic studies should be regarded as part of a process, not as a single product, and sequenced over time.

Diagnostic reviews should be conducted according to open and transparent processes — There should be full consultation with all stakeholders before completion. There should be “no surprises” when the final report is published.

Understanding the institutional and governance context — Reviews of public financial management systems are not simply "technical" exercises. They require a full understanding of the underlying governance arrangements in a country, the informal rules and incentive structures, and the factors that can undermine efficient and effective delivery of public services through waste, mismanagement and corruption.

Performance measurement

9. The following principles guide the elaboration of good practice in performance measurement:

- The measurement framework needs to encompass the critical aspects of public financial management — covering budget formulation, execution, reporting, and review — and be fully integrated with diagnostic reviews and processes.

- The measurement framework should encompass internationally agreed codes and standards — which represent the target for public financial management systems — where appropriate. This leads to two specific requirements:
  - Codes and standards need to be developed to fill existing gaps in coverage.
  - Developing countries should fully participate in the development and formulation of codes and standards.

- Performance measures should be comprehensive with respect to the critical areas to be covered without being excessively numerous. They should be readily understandable, cost effective, and capable of being calibrated to cover different stages of development and monitored on a regular basis. They should be acceptable to both partner countries and donor agencies and, where appropriate, consistent with current and proposed relevant international codes and standards.

- While there can be no single overall measure of public financial management performance, it is necessary to avoid having too many indicators. In addition to indicators of the overall effectiveness of the system, it can be useful to have more detailed indicators of specific aspects or areas of public financial management, e.g., public procurement, internal control and external audit.
Good practices in diagnostic work

Planning the review

10. As far as possible donors should seek to satisfy their requirements by relying on the diagnostic reviews that are already available, or that will be made available within a reasonable period of time.

11. Where individual donors’ requirements are not satisfied by available diagnostic reviews, they should seek to limit unnecessary duplication of work by collaborating with other donors and stakeholders and sharing the results of their reviews.

12. All donors should promptly share information on plans for carrying out diagnostic work in a particular country.

13. The reasons for conducting the review and its relationship with the overall country development strategy and the strategies of participating donors should be clear to, and accepted by, all participants at the beginning of the review.

14. Collaboration between partner country and donors is as important as collaboration between donors. Collaboration may take a number of forms:

- **Joint undertaking of a diagnostic review** — With work being undertaken by staff or consultants of any number of development partners, including the partner country.

- **One or some partners undertaking the study** — This may include the partner country undertaking a self-assessment, with appropriate review by donors, or one or more donors carrying out work on behalf of a wider group, with others providing funding or specific technical resources or indicating their intention to use the results of the study.

Conducting the review

15. The nature and extent of collaboration should be agreed and documented at the start of the planning process. This should include:

- The role of the partner country in the work.

- Whether there is to be a joint or separate reports for different donors.

- Whether there is to be a joint report, and the preparation of a joint initiating memorandum.

- Which donors may be lead-participants, and which may take a more secondary role. Where there are many donors interested in a diagnostic study it may be necessary to limit the direct participation of some so as to keep the process cost-effective. This would be achieved through mutual agreement.

- The staffing contribution and division of labour and costs between the participants.

- Processes for communicating conclusions with other stakeholders.

16. Obtaining objective information on the quality of the public financial management system requires consultation with all stakeholders in the partner country. Apart from central ministries such as Ministry of Finance, these include spending ministries, parliaments, the business community and civil society.

17. Progress and emerging conclusions should be shared with all participants during the course of the review through regular meetings. The partner country should be encouraged to share draft conclusions with other country stakeholders before finalisation.
Quality assurance

18. All participants have a shared interest in achieving a quality diagnostic review. Where joint reviews are carried out, quality assurance arrangements should be agreed at the planning stage and recorded in a jointly owned paper. These arrangements will normally provide for a regular review of work done by each participating organisation, and for clearance by others before the report is issued.

Sharing the review report

19. All review reports will be shared to the fullest extent, observing individual participating donors’ disclosure policy and the prior agreement reached with the partner country.

Follow-up activity

20. Donors will work to develop an understanding with the partner country that the review is intended to bring about improvements in the public financial management system. This should lead to the elaboration of an agreed action plan and follow-up activity.

21. Collaboration on follow-up is important and should also involve identification of capacity development needs and provision of technical assistance where necessary. The partner country should co-ordinate this process and avoid donor competition.

Updating of the review

22. Consistent with the review’s role as a knowledge tool, the information needs to be kept up to date. While a full diagnostic review may be undertaken only every three to four years, updating of the overall assessment should be undertaken every year. This includes using appropriate public financial management performance indicators. Desirably, this should take place through a joint mechanism agreed between the partner country and donors and built into the country’s budget cycle.

Box 3: Improving public oversight of public expenditures

Bangladesh — During 1999-2000, a Country Financial Accountability Assessment was conducted by the World Bank and UNDP with participation from the Ministry of Finance, line ministries, parliamentary oversight bodies and private firms of accountants. The assessment focussed on the quality of financial accountability and transparency in Bangladesh, and made recommendations for improvements. The financial management standards and practices of agencies using public funds was compared to international good practices as well as those of external oversight agencies—nine Audit Directorates of the Comptroller and Auditor General’s Office, parliamentary committees concerned with public expenditure, donor agencies and the media. It included an assessment of the steps that would needed to support a shift by donors from projects to budget support and sector programmes. Among the responses of the government is the creation of an independent Public Expenditure Review Commission, headed by a retired Comptroller and Auditor General. The Commission will review all aspects of public expenditure on an annual basis and report to the government and to Parliament.

2 See the Country Analytic Work Website at www.countryanalyticwork.net, also referred to in the Good Practice Paper Country Analytic Work and Preparation of Projects and Programmes.
Box 4: Partners support government led diagnostic process

**Tanzania** — The Government of Tanzania owns and leads the diagnostic work program in public financial management — and that is what accounts for its success. The programme, of which the centrepiece is the annual Public Expenditure Review (PER)—is closely integrated into the government’s budget cycle and involves a broad cross-section of stakeholders, and close partnership with donors.

The PER process has evolved from its traditional role of external evaluation of budget management to support the government’s programme to improve budget management within a medium term expenditure framework. It supports better donor co-ordination by ensuring that aid is consistent with budgetary objectives and priorities and increasingly integrated in the budget.

More recently, the PER has been supplemented by the Country Financial Accountability Assessment (jointly undertaken by the World Bank and DFID, published as a government document, and shared with all donors) and the Country Procurement Assessment Review, which look at critical aspects of budget execution. The programme has the following benefits: (a) donors share their sector specific or thematic experience, to the benefit of all who participate, (b) more effective use of resources in undertaking technical studies on budget issues, (c) a higher profile of budgetary issues in the work of all parties, and (d) a platform to support the shift from project to budget support by several donors.

**Good Practices in performance measurement**

23. Given the emerging nature of work in this area, good practices have yet to fully emerge. However, based on work to date, the following appear important:

- Partner country governments and donors should collaborate in the setting and monitoring of country-specific performance indicators in public financial management.

- Donor collaboration should take place within a government-led strategy for improving the overall management of public finances that sees performance measurement fully integrated with diagnostic work and capacity building efforts. Common performance indicators can avoid governments being presented with an excessive number of — potentially conflicting — targets, and can serve to co-ordinate donor capacity building efforts.

- Given the absence of a comprehensive, internationally accepted performance measurement framework in public financial management, donors should support work on the development of such a framework. They should also ensure that developing country conditions and voice are reflected. Where available, donors should be guided by existing international standards, codes and approaches in formulating country-specific performance targets, as appropriate to country conditions (See Box 5 below).

- Indicators of public financial management performance assist donors in assessing risks to their programmes. While donors should collaborate in the formulation of performance indicators in individual countries, donors decide individually on the nature and level of resource transfers in a given set of circumstances. They will take into account previously agreed measures.
**Box 5: Elements of an emerging performance measurement framework**

Among the elements of an emerging international framework for performance measurement in public financial management are:

- **International standards**, such as the International Public Sector Accounting Standards (IPSAS) of the International Federation of Accountants and the auditing standards of the International Organisation of Supreme Audit Institutions (INTOSAI). Work is also commencing on IPSAS for development assistance and budget reporting.

- **Codes of good practice**, such as the IMF’s Code of Good Practices on Fiscal Transparency and budget classification procedures promulgated by the IMF (Government Finance Statistics) and United Nations (COFOG).

- **Current benchmarks**, such as the set of 15 performance benchmarks in public financial management used by the IMF and World Bank in tracking poverty reducing expenditures in Highly Indebted Poor Countries (HIPC’s). An updated set of these benchmarks will be available in 2003. In addition, UK DFID has developed a set of public financial management performance benchmarks in the context of managing fiduciary risk when providing direct budget support.
**Note 3 – Indicators of good practice in Measuring Performance in Public Financial Management**

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<tr>
<th>GOOD PRACTICES</th>
<th>INDICATORS</th>
<th>SOURCE OF INFORMATION</th>
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<tbody>
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<td>Diagnostic coverage without duplication.</td>
<td>Reduction in number of diagnostic reviews that address the same area.</td>
<td>Country Analytic Work Website.</td>
</tr>
<tr>
<td></td>
<td>Reduction in number of donor missions.</td>
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<tr>
<td>Higher impact of diagnostic work.</td>
<td>Proportion of reviews carried out in the context of country strategy.</td>
<td>Information on country programmes and Country Analytic Work Website.</td>
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<td></td>
<td>Proportion of reviews carried out through agreed collaborative mechanisms.</td>
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<td>Agreed approach to building public financial management capacity.</td>
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