# MANAGING PUBLIC FINANCE AND PROCUREMENT IN FRAGILE AND CONFLICTED SETTINGS

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ABSTRACT

Successful transition from conflict and fragility hinges on the quality and legitimacy of public financial management (PFM) systems. This article shows that such systems develop asymmetrically in these settings. Formal aspects of modern systems are adopted, but a layered series of informal arrangements govern resource allocation. Analysis of data from PEFA assessments of 101 countries explores aspects of this asymmetry and different explanations are considered for why elites seem to choose not to invest trust, resources, and capacity in making mainstream PFM systems functional. These explanations focus on the incentives created by three "public" resources: illicit flows, domestic revenues, and strategic, or aid flows. Mainstream PFM systems are applied to a small part of these flows. The illustrative case of Cambodia shows how a layered system has emerged to govern such flows, undermining the influence of formal public finance management systems. The article offers suggestions to address these issues.

## INTRODUCTION

Many scholars have suggested that successful societal evolution hinges on the systems and procedures societies develop to manage public finance (Bates 2009; Schumpeter 1991(1918); Tilly 1992; Therkildsen 2002; Moore 2004). In the aftermath of the Second World War, there were strong incentives for elites to invest in the public agencies and systems to ensure that public finances were well-managed. As a result, these institutions have become legitimate means for sustaining peaceful 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. This is in marked contrast with the experience of today’s fragile and conflicted states, where global responses have become increasingly concerned about the high probability that enduring institutional fragility will result in the resumption of violence. It is not simply, as the 2011 World Development Report argues, that such transformation is slow and the trajectory is uncertain (WDR 2011, 11). Many have achieved a sustained turn-around (Chauvet and Collier 2006, Table 1). The problem is with states that suffer from a long term “shrinkage in effective public authority” (Moore et al. 2009). A small group of oligarchs, with vastly greater material power than other elites, may rule collectively through self-managed institutions, with, in some cases, one of them as the undisputed leader. Institutions are run and laws enforced based on the personal dictates of the ruling group. In some cases, this arrangement deteriorates into a situation where there is no stable, superior authority, and an unstable equilibrium prevails among competing, well-armed warlords for territory, resources, and populations. In other cases, ruling oligarchs divide coercive resources between those they hire privately and those deployed by quasi-states through which they govern (Winters 2011). In these contexts, authoritative power may not shift to impersonal institutions that provide coercion and law enforcement according to well-defined rules, but remain in personalized arrangements drawing 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, illegitimate, and widely corrupted (Levi and Sacks 2009).

Anticipating that this condition is chronic, donors consistently respond by installing tough parallel mechanisms 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 cascade of reforms is typically introduced to create the legal framework, the institutional architecture, operational systems, human capacities, and control arrangements for public financial management.[1] The premise is that adopting such institutional forms – otherwise known as "building capacity" to correct so-called "weak links" – will make it possible for fragile states effectively to build impersonal institutions with well-defined and enforced rules, and thus contribute to state legitimacy and authority. As the newly installed arrangements begin to demonstrate their efficacy, it is anticipated that the donors' parallel mechanisms will become aligned with them, and eventually dissolve. More often, however, the parallel mechanisms become layered alongside, and cast durable shadows over the formal institutions (Craig and Porter 2012). 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.

This article addresses such situations, advancing the literature on public financial management (PFM) in development. It builds directly on past work (Andrews 2004; 2011; Brinkerhoff and Goldsmith 2004; Ear 2007; Hope 2001; Santiso 2004; Zaltsman 2009). Section 1 illustrates these points, 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 nature and volumes of resource flows, both domestic and international, have affected the incentives to which governing oligarchs and lesser elites respond in fragile settings, and in part explain the findings in Section 1. An illustrative case of Cambodia is presented to show the long term effects on PFM institutions of the choices made in early stages of peace building. This case presentation builds on the experience of the authors in Cambodia, and draws simultaneously from literature on PFM reform in the country (including Gottsman 2003; Pak 2010; Taliercio 2009). Finally, Section 3 suggests that the central challenge in public finance and procurement interventions is positively to influence the incentives to which elites, national as well as local, inside and around public authorities, respond in contexts of fragility.

## PFM IN FRAGILE AND CONFLICT AFFECTED STATES: THE RECORD

There are no composite measures tailored to the comparative analysis of public finance management in fragile or conflicted settings. The Public Expenditure and Financial Accountability (PEFA) performance measurement framework used in recent studies (e.g., Andrews 2011) provides a useful point of reference, however.[2] It gives an opportunity 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” and disaggregates this consensus into PFM indicators and dimensions 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” (Wescott 2008, 22).

*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 that had completed at least one PEFA assessment by February 2010. In the nineteen fragile countries (classified as such according to IMF criteria), scores on 64 of the 74 PEFA indicators and dimensions[3] (listed in PEFA Secretariat, 2008 as ‘PI-4 to PI-28’) 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).[4] 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.

<<<INSERT FIGURE 1 ABOUT HERE>>>

*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, and poorly on others. One way of summarizing these patterns of performance is to distinguish between three dimensions, that is, 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. For example, 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 – for example, 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"[6] entities**. The former includes PEFA dimensions under the direct control of central bodies – such as the Ministry of Finance – that play regulatory, "rules of the game," and summary reporting roles. Deconcentrated dimensions refer to those requiring multiple transactions by 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 ministries, departments and agencies.

There is clearly overlap among the three dimensions, but broadly speaking, *de jure*, upstream and concentrated dimensions are representative of *formal* features of the PFM system. *De facto*, downstream and deconcentrated are representative of a more difficult "functional" adjustment that requires actually implementing a new law or regulation, or coordinating the work of many agencies, or working downstream in the budget cycle.

Figure 2 shows differences between averages scores on dimensions and indicators assessed to be *de facto*, *de jure*,[7] deconcentrated, concentrated,[8] upstream, and downstream,[9] in fragile and non-fragile groups.

<<<INSERT FIGURE 2 ABOUT HERE>>>

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 deconcentrated, 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*, deconcentrated and downstream dimensions average about 1.5. These gaps resonate with common knowledge.[10] Section 3 will consider various actions that may help governments to address these gaps, but it is useful first to look more closely at process weaknesses.

To examine more closely the areas of greatest process weakness, 31 African countries were isolated in the 101 country PEFA set, with 10 of the 31 being fragile.[11] This analysis re-affirmed the general findings. There were 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 such as cash management, procurement, payroll control and internal control.[12] Reinforcing the observation above, 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.

Figure 3 aggregates PFM dimension scores into 18 broad PFM process areas, running from strategic budgeting (for example, medium-term expenditure frameworks) 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.

<<<INSERT FIGURE 3 ABOUT HERE>>>

In sum, the three dimensions depicted in Figure 2 help unpack different aspects of the disconnect between form and function in PFM in fragile contexts. First, there is a disconnect between the adoption of *de jure* measures, in which politicians are engaged in the passage of laws and regulations, policy statements and fiscal instruments, and *de facto* practices, where laws, policies and instruments remain disconnected from results on the ground, and from political accountability for results. The second measure provides a different take on this: the formality of PFM processes is strongest at the center, 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, upstream PFM processes (budget making, etc) tend to be more heavily invested in than the downstream processes of achieving functional results in revenue collection and converting expenditures into services. Broadly similar results have been reported in a recently published study by the PEFA Secretariat.[13]

## SECTION 2: EXPLAINING THE GAPS: CONTEXT, RESOURCE FLOWS AND PFM MECHANISMS

All countries are different, and one must be wary of generalization. Organization for Economic Cooperation and Development (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. This 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, it is easier to account for areas where they perform better than it is to explain poor performance. Governing officials will seek to derive legitimacy from multiple sources. *De jure*, upstream adjustments to PFM systems feature highly in reforms promoted by donors. By their nature, these adjustments require fewer actors, and can be achieved by stroke-of-the-pen measures or “executive orders” that import readily available global models. Thus, that fragile countries do tend to score better on “budget quality” where external support has been provided[14] may in part be explained by the fact that officials are able to garner global legitimacy, and sometimes not inconsiderable local standing by being seen to adopt “best practices.” As others have pointed out, the formality of public finance and procurement processes are one part of the “rituals of reason” used by dependent organizations to declare their rationality and endow themselves with legitimacy (Czarniawska-Jorges and Jacobsson 1989; Ezzamel et al. 2007). Formal processes 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 the context of fiscal volatility (Caiden and Wildavsky 2003, 67, 283, 301) and a “twilight zone” that is opaque, core and difficult to influence and change (Wildavsky 1992, 598).

Institutional theory goes only so far 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 expenditure 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 center, and more frequently entail 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 exemplify only an exaggerated form of the kinds of weaknesses found in other countries – in other words, that the problems are merely transitional. Yet this underplays key features of PFM in fragile contexts and the particular ways that they have been affected by global shifts, the nature of the resource flows that PFM must grapple with, and how the mechanisms employed to manage these resource flows significantly raise the stakes in achieving good PFM systems.

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

Changes in the global economy since the 1970's have undoubtedly affected PFM systems in fragile contexts. The globalization of demand for high-value and scarce commodities (oil, diamonds, minerals, narcotics), the reduced costs of transportation, the sophistication of illegal networks and the relative ease of hiding financial assets and evading detection, of manipulating poorly paid officials in fragile countries, and of purchasing sophisticated weapons, all support wealth defense and accumulation by oligarchs and significantly ramp up incentives for personal enrichment (Shaxson 2011). The salience of these points becomes more evident when considering public resource management in the wider context of three different resource flows – domestic, illicit and strategic – the latter category including humanitarian aid and various kinds of concessional financing for commercial or foreign policy purposes.

## Resource Flows: Domestic, Illicit, and Strategic

Domestic resource flows managed within the national budget are amongst the first casualties in conflicted settings. There is much debate about the governance payoff of domestic revenue reforms; some argue that if people are required to pay higher taxes they will be better motivated to hold their leaders accountable (Moore 2004; Levi and Sacks, 2009). Yet domestic revenue is typically not a priority in policy dialogue between donors and governments (Boyce and O'Donnell 2007). From available data, the patterns are unclear (Table 1), but in such contexts it is difficult to establish what Scott (2009, 10) calls "fiscally fertile" zones, indeed, there are strong political incentives not to do so. Oligarchs are typically very effective in lobbying for low effective taxation of their considerable income. Where the dominant rule systems of the state are weakened by conflict, people have created multiple and very durable systems for resisting taxation, efforts by the state to administer their natural resources or to incorporate them in nation building projects (see Scott 2009).

<<< INSERT TABLE 1 ABOUT HERE>>>

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 official appointments. It is difficult to establish the volumes or drivers of illicit flows[15] given the obvious motivation to hide wealth accumulated in this way from public scrutiny and the sophisticated systems that make it possible to do so (Shaxson 2011). The Global Financial Integrity program – which tracks only cross border flows of illegal money – estimates that $850 billion to $1 trillion in funds are involved annually, and around half comes out of developing and transitional economies (Kar and Cartwright-Smith 2008). 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).[16]

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).

<<<INSERT TABLE 2 ABOUT HERE>>>

Despite donor policy urging harmonization and alignment of strategic and domestic flows, the former will generally by-pass mainstream government systems and 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 mainstream government systems of financial management will apply to only a part of total resource flows – to take Cambodia's case, only about a third of what are nominally "public" finances – illicit, domestic, and strategic finance – will enter the formal, mainstream system (including illicit rents and less than 20 percent of aid flows). This means that a significant share of political contest will occur outside these formal systems. Second, to a considerable extent, the effectiveness of formal systems will be weakened by the diversion of administrative talent and energies by as a result of incentives to manage strategic and illicit resource flows. Third, with legitimacy and effectiveness weakened, formal systems will be less able to marshal the authoritative power to implement what the formal system requires. These points will tend to reinforce the isomorphism observed earlier in this section: formal PFM systems will tend to exist more in form than in function.

These observations are consistent with commentary on the layered nature of governments in heavily aid dependent settings – patronage systems operating both on- and off- budget, parallel systems for governing aid flows, with both sitting alongside the formal machinery of government (Craig and Porter 2006; Brinkerhoff and Goldsmith 2005; Hughes 2009; Ghani et al. 2007; Boyce 2008; Leader and Colenso 2005). There exists no comparative country analysis of how this layering occurs. Instead, the next section summarizes findings from research in one context, namely, Cambodia (Craig and Porter 2012).

## Medium Term Effects: Strategic Resources in a Specific Context

What has occurred in Cambodia, more than two decades after the end of violent conflict is, of course, unique, but not substantially so.[17] In Cambodia donors have been actively engaged in much cited and innovative reforms in public financial management (Taliercio 2009). It has also been the site for experimentation over the past decade with sector wide approaches, contractualized service delivery, local government decentralization and several episodes of civil service reform. Over this period, several other PFM systems, many instituted well before the United Nations Transitional Authority of Cambodia intervention (UNTAC 1992; 1993; Gottsman 2003), have also been developed by the Cambodia People's Party (CPP) (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 market 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 financial gains in urban property sales, commercial agricultural concessions, and market regulation (Pak et al. 2007; Pak and Craig 2008). And, since effectively coming to power in 1979 the CPP has consolidated control over national, provincial, and local politics and administration (Pak 2010). Table 3 illustrates the main features of three predominant layers of PFM systems that have developed to manage public resources in Cambodia.

<<<<INSERT TABLE 3 ABOUT HERE>>>>

Table 3 describes a situation in Cambodia that mirrors common experience in many fragile contexts. Some features reflect dualism – columns 2 and 3 – in which donors finance the bulk of capital investment and a good share of non-salary recurrent spending in the social sectors. They are able to incentivize 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 party system (Col 1) that enjoys high levels of trust by elites aligned with the Party, is highly discretionary and is internally disciplined, but has low political contestability. The system described in column 1 is able to mobilize significant revenues, control the regulation of natural assets on which livelihoods depend, and through patronage arrangements, the performance of the civil service establishment, the judiciary, and the public security system.

While PFM reformers and donors are alert to the layered nature of PFM (in Cambodia, see UNCDF 2010), the typical policy outlook reinforces the problem. Where systems are seen to be chronically weak, fiduciary risks are managed by installing parallel systems, although these will exacerbate the difficulties of creating trust, capability, and legitimacy in the mainstream PFM systems (Craig and Porter 2012). A vicious circle results; chronic weaknesses in formal systems impel increasing donor engagement in direct social service delivery (albeit nuanced around supposedly “country-owned” approaches). Frustrated by the fact that actual downstream performance depends on a civil service they can only attempt to influence by salary supplements, they go around it by private-sector or NGO contracting, or augment it through technical assistance to install modern financial management systems.

In a medium-term perspective, appreciating the existence of multiple layered, rather than simply 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 influence the choices officials make in relation to investing political capital, trust and expertise in the formal systems for managing finances and procurement.

## OVERCOMING GAPS: BUILDING DURABLE MEDIUM-TERM CAPABILITIES

Section 1 highlighted three dimensions of the disconnect between form and function in PFM systems in fragile, conflicted settings. Section 2 speculated why this may be more pronounced in fragile situations – and suggested that donors are embroiled in a three-part layered system through which public financial management needs to be understood.

Aid flows are called here strategic resources not simply because they reflect diplomatic and commercial 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 imported by analogy from somewhere else, the task is to use strategic resources in ways that influence the rough and tumble of elite contest, to have an impact on incentives in ways that will drive positive changes in formal state institutions and actual behaviors.

This is not to say that PFM interventions should jettison the basics, namely the need to achieve aggregate fiscal discipline, to allocation resources on priorities, or to make spending accountable. Consistent with the PEFA disconnect findings, however, it is important to do this in ways that enhance the incentives for officials 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. The following considers ways in which strategic resources might be used to add incentives for officials to avoid the perverse effects of shadow systems, donor or informal, and to direct social contests about how resources are to be mobilized, allocated and managed  legitimate and effective formal systems.

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

Under this area, there are three priorities:

First, central to fostering political incentives to create and vest public institutions with authority for 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 and criminal activities. Although regulation in this area has increased (post-9/11 and post-financial crisis), 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 in 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; Shaxson 2010). More is needed to extend their reach and effectiveness: EITI (Extractive Industries Transparency Initiative) 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). In moving forward in these areas, there is a need to be realistic: wealthy oligarchs will ensure that their wealth is not affected by these measures, even though lesser elites may find their illicit activities somewhat constrained. Second, much has been said about the potential of "common accountability frameworks" involving government and donor partners (Ghani and Lockhardt 2008). There are many variations in how policy 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 L'Este, Sudan, Uganda, Mozambique). But their effectiveness in creating sites for debate and securing commitments by counterpart officials is limited in two ways – by the fact that only a small fraction of aid to fragile states flows through national finance and procurement systems, and by donor aversion to funding recurrent costs. It is well understood that donor practices create perverse local incentives, as reflected in the three way layers observed in Cambodia. Donor financing of government budgets is a contentious issue, since weak, government financial systems may not be sufficiently robust.

But while not common, there are numerous dual control arrangements that at least in principle create incentives to bring inside the formal system of government spending an increasing share of resources typically sequestered off-budget along with domestic and donor resources, in which mutual accountability agreements can deliver practical results.[18] A major potential dividend of bringing all strategic and domestic resources under one predictable and accountable budgeting and control system is that it provides a strong incentive to both government and donors to ensure that a merit-based, high capacity civil service is in place to manage this system. At present, this core issue is too often either sidelined in special-purpose civil service remuneration projects that have a poor record (World Bank 2008) or, is relegated to an ephemeral part of donor-funded social service delivery and community-driven development projects that use parallel systems to incentivize frontline performance (Bloom et al., undated; World Bank 2005).

Third, aid programming that takes into account whole of government financing for fragile states could make for more productive dialogue about taxes, and about how social and economic life is regulated. While the ways that aid may undercut incentives for domestic taxation continues to be debated, aid is infrequently used strategically to improve revenue performance in fragile states (Boyce and Foreman 2010). Whole of budget financing or challenge grants might be used to incentivize elite decisions to bring more revenues into the budget process (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 consequences of the way governing elites regulate assets of prime importance to the poor, including natural assets and the conditions of market entry into occupations or areas of the economy.

*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 contractualizing of services, and priority actions programs. These solutions are always context- specific, and can at times have perverse outcomes for peace, security, the effectiveness of service delivery and on the coherence and credibility of PFM systems (Brick 2008; Dasgupta and Beard 2007; Barron et al. 2009). In PFM terms, 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 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.[19]

Nonetheless, 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 either-or situation (decentralization versus centralization). Where PFM systems work  best, they reflect strengthened ties between concentrated and deconcentrated agencies. When linked with authentic political decentralization, and where the focus is on enhancing the volume of locally control expenditures (relative to revenue collection), fiscal decentralization has been shown to improve government responsiveness to local priorities and reduced the probability of ethnic conflict (Siegle and O'Mahony 2008).

Second, public procurement can provide a far-reaching platform for constructive engagements among formal structures, local elites, and donors around service delivery. 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, domestic officials are often hostile to approaches focused on mandating compliance to "best practice" procedures. In line with the above, efforts to increase the efficiency of purchasing (especially relating to buying commodities) may have the greatest likelihood of immediate impact, as well as medium term consequences for the ability of formal systems to deliver services. In a similar fashion, efforts designed to get good value for money from purchasing done at sub-national levels may improve donor comfort and official acceptance more than heroic efforts by understaffed authorities to enforce compliance to often poorly understood rules that yield unenforceable contracts. Useful strategies that may create incentives for governing elites to invest talent, resources, and trust in formal procurement systems include a range of non-orthodox approaches including use of non-competitive bidding arrangements, more frequent use of variable quantities contracts, inclusion of contractual requirements to support employment, and special arrangements to fast-track procurement that cut a path through the thicket of donor ex ante controls. As in other reform areas, procurement reform is more likely to improve the speed and value of smaller contracts going to lesser elites than to have an impact on large contracts where oligarchs and their interests are bidding.

Third, positive experience with PFM reforms in fragile situations underscores the need for more attention to leadership, coalition building and change management. Recent work 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; Andrews et al.

forthcoming). 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 of which may or may not be sequential, 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 and coalitions include people who need to play multiple roles (not just having one or two talents), have multiple sets of connections, not just one, and can thus support more far-reaching and influential institutional changes. Leadership groups also carry change conversations among themselves allowing new ideas to emerge from ongoing dialogue 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 such as 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.

In other words, PFM reform progress happens when groups are engaged in dialogue about such reform. This dialogue needs to bring in all key players, including those who actually implement reform. Communities of practice and other broader network structures can be effective in building broad leadership coalitions around key PFM problems – for example, how to pay bills on time, how much discretion to delegate to particular decision points, or to allocate enough money to basic services. Combining attention to leadership and coalition building with performance based resource sharing agreements, and efforts to increase the efficiency of purchasing could lead to better results for governments and their development partners in the future.

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NOTES

[1] See, for instance, Allen 2009; Boyce 2007; Campos and Pradhan 1998; OECD 2009; Schiavo-Campo 2007; Wescott 2008; World Bank 2006.

[2] 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.

[3] Ten additional indicators/dimensions relate to outcomes and donor practices.

[4] The IMF does not directly consider PFM systems when determining whether a country is fragile or not. The main factors are political and economic, assessed at broad country level.

[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] By this we mean an administrative process where decision making authority is delegated but remains within the same network of accountability

[7] *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.

[8] 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).

[9] 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.

[10] 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).

[11] 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.

[12] 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).

[13] A separate study looked at 33 PEFA comparative assessments intended to measure changes over time, of which 11 were in fragile states. The latter were carried out in 8 countries, and 3 subnational jurisdictions in Ethiopia. Both for all countries and for fragile states, there were more indicators/dimensions maintaining an A score or improving (32% for all countries, 29% for fragile states) than maintaining a D score or worsening (19% vs. 16%), and maintaining a B or C score (21% vs. 19%). Formal features were more likely to improve or maintain an "A" score, while functional features were more likely to worsen or maintain a "D" score. The greatest disparity was between concentrated and deconcentrated measures, with the former showing much greater improvement. *De jure* measures

improved slightly more than *de facto* ones, while there was almost no difference in improvement between upstream and downstream measures. There is also a large disparity between formal vs. functional measures that have worsened or maintained a "D" score, with many more cases of the latter than the former. PEFA Secretariat 2011, based on 2009 list of fragile states in OECD, 2010: 160.

[14] 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.

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

[17] Elements of this can be found at various times in Afghanistan, Uganda, Pakistan, and West Bank Gaza, to name a few. See, e.g., Snyder and Bhavnani 2005, Rakner et al 2004, van de Walle 2007, Fayyad 2010, Khan 2005. A comparatively study of the experiences of Mozambique, South Africa, Rwanda, Cambodia

and Vietnam prepared for the *World Development Report 2011* also suggests that the findings in this article on Cambodia may be more generally applicable. See http://wdr2011.worldbank.org/input-papers

[18] Liberia's Governance and Economic Management Action Program involving "dual key" oversight by domestic and external agency officials, and the agreement to "jointly brand" activities financed by government and donors in Aceh in the aftermath of the tsunami and peace agreement are cases in point (World Bank 2011).

[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 latter 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. The type of decentralization, the particular social context and conflict experience all impact (Bardhan 2002, 2005) on whether it improves the way services are delivered, natural assets or local market activities are regulated, accentuates differences between regions and foster citizens identification with ethnic, geographic or minority group identities (Brancati 2006), aids central state penetration, for good or ill, exacerbates local conflict (Green 2008), enhances autonomy or the power of opportunistic elites (Rose-Ackerman 1999, Persson and Tabellini 2002) or weakens incentives to invest in national public goods and priorities, thus generating new tensions (Diprose and Ukiwo 2008).

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Table 1 Domestic Resources

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

Source: See WDR database and codebook. In addition, IMF Article IV staff reports for Mozambique 1996, 2003; Haiti 1999, 2004; TL 2000/1, 2005/6; SI 2002, 2008; Liberia 2008/9; Uganda 1990/1, 1996/7; Cambodia 1998, 2001.

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 after 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.

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

Table 2: Strategic Resources

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

Source: WDR database codebook

Notes: See for Table 2.

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

Table 3: PFM systems for illicit, domestic and strategic resource flows in Cambodia

| **PFM systems** | **1. Illicit Flows – political systems** | **2. Domestic flows – formal systems** | **3. Strategic flows – donor systems** |
|---|---|---|---|
| Source of funds | Rents from NR, market access, property speculation, tithes on business, regulatory gate-keeping 'ink money' and fees from appointments, postings, transfers. | Formal, on-budget (customs, excise, fees, tax, tourism levies) revenue.<br><br>Debt relief, limited quasi budget support | Global compacts, multi- and bilateral agreements, trust funds, projects, programmatic/ sector financing |
| Purposes | Personal enrichment, loyalties, prestige, ceremony, virtue, regime durability.<br><br>Extensive though very uneven funding (electoral cycles, business conditions).<br><br>Domestic spending mimics donor funding patterns – small infrastructure, facilities. | Establishment funding, low civil servant salaries, minimal non-salary recurrent, or capital<br><br>Maintaining of establishment positions to superintend informal gatekeeping opportunities | Substantial though often uneven and unreliable, often requiring fund-specific governing arrangements.<br><br>Focused on capital and non-salary recurrent, skewed to infrastructure and social sectors<br><br>Meeting fiduciary standards in executive funding flows (building "good governance"); audit, advisory, TA around this |
| Operational reach | Security. Police. Judiciary.<br>Major investment project approvals.<br>District party working groups.<br>Commune chiefs.<br>Regulation of natural assets for livelihoods.<br>Patronage-based projectized delivery. | Formal donor-external relations.<br>Central line ministries and province departments.<br>Regulatory and spending units at local level, but under central party influence | Central and deconcentrated project management units.<br>Social sector non-salary spending<br>Contracted NGOs<br>Private sector capital execution<br>Local project committees<br>Geographically fragmented |
| Incentive systems & capability | High levels of trust and local discretion.<br>Low political contestability or transferability. | High incentive for enactment of executive forms: compliance formality enables rents.<br>Low levels of trust and | Formalized accountabilities via contracting, salary incentives. |

| | | | |
|---|---|---|---|
| | High political accountability for delivery and quality.<br>High capacity in NR and asset regulation, but low formal political accountability. | formal capacity<br>Low political accountability for delivery or responsiveness<br>Low capability and establishment controls<br>High capability in natural asset regulation | Low political accountability (though some electoral dividend) for delivery via this system<br><br>Low capability in regulatory and establishment control |

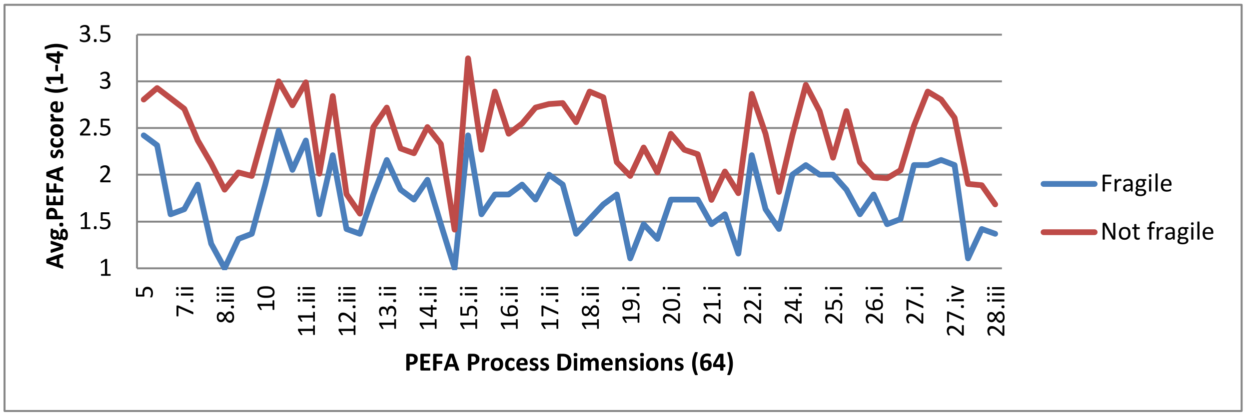
Source: adapted from Craig and Porter 2012.

FIGURE CAPTIONS

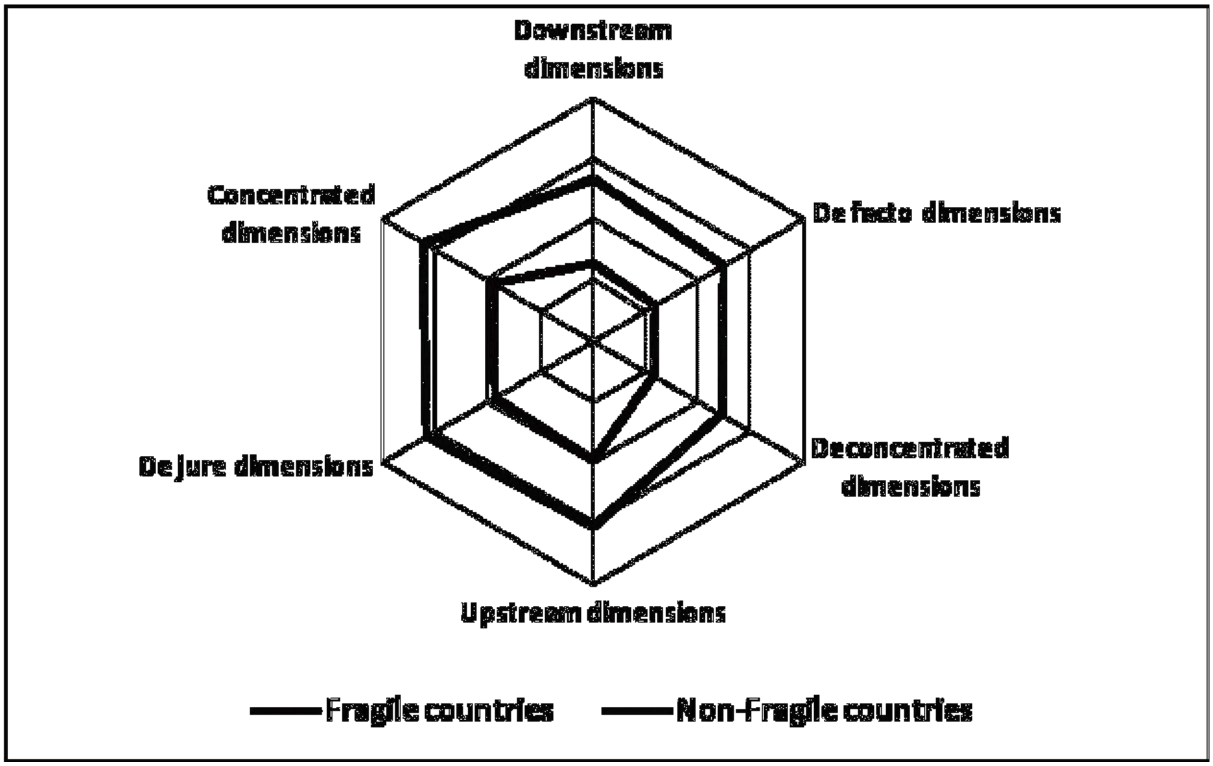
Figure 1. PEFA score gaps between fragile and non-fragile countries. Source: Authors' analysis. Note: means are complex measures when talking about ordinal data such as those generated by PEFA assessments. They can be hard to interpret, given that the distance between ranks (A, B, C and D) are not necessarily the same (Andrews 2011). Means can still be used, as in this Figure, to illustrate the central tendencies of groups and allow comparisons. They are used here partly because of the common-ness of such measures with PEFA data (see De Renzio 2008). Readers should note the implicit assumption of equal distances between ranks

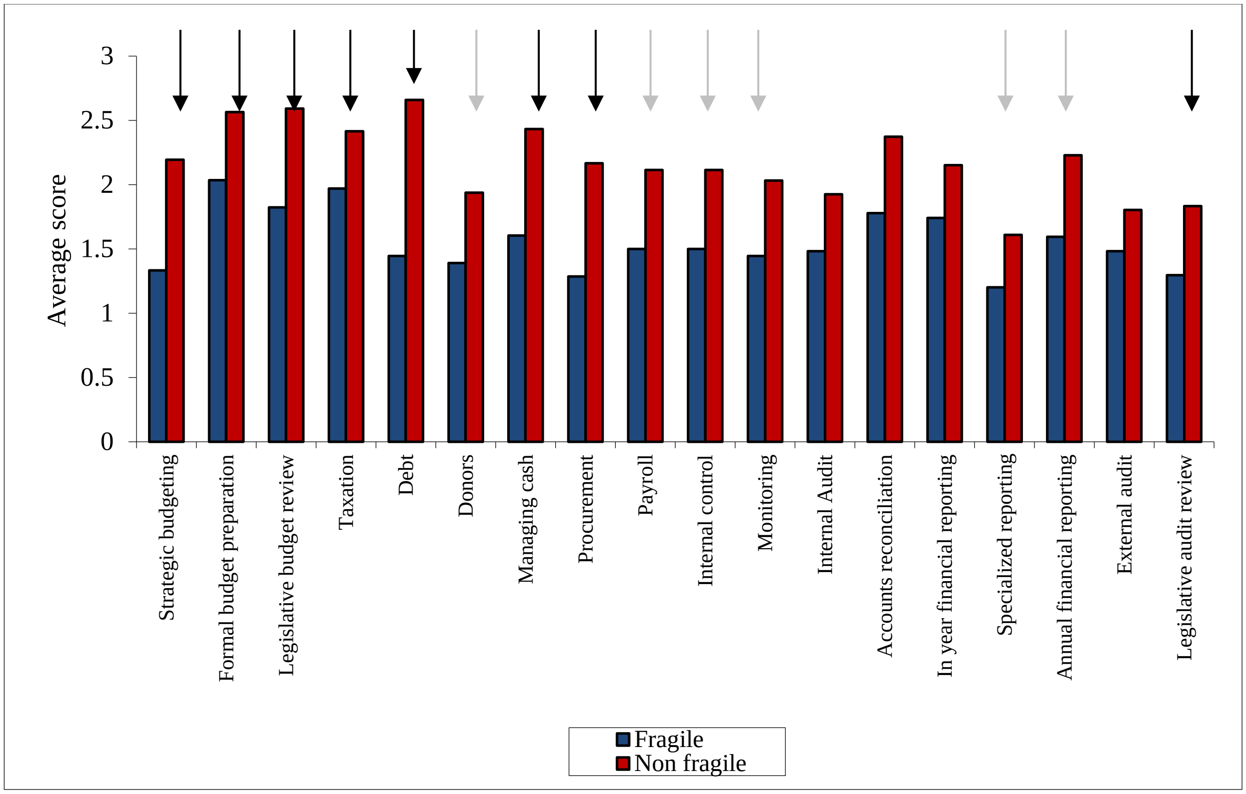
Figure 2. Differences in different dimension types point to reform strengths, weaknesses. Note: Gridlines reflect average scores on the various dimension types, starting at 1 (D) at the center and radiating outwards in increments of 0.5, to 3 at the outer-most gridline. *Source: Authors' analysis*.

Figure 3. Comparing average process index scores, in fragile and stable country groups. Note: The dark arrows indicate statistical significance of the difference in means at 0.01; lighter arrows indicate statistical significance of the difference in means at 0.05.



Avg.PEFA score (1-4)
3.5
3
2.5
2
1.5
1
5
7.ii
8.iii
10
11.iii
12.iii
13.ii
14.ii
15.ii
16.ii
17.ii
18.ii
19.i
20.i
21.i
22.i
24.i
25.i
26.i
27.i
27.iv
28.iii
PEFA Process Dimensions (64)
Fragile
Not fragile


Downstream dimensions
De facto dimensions
Deconcentrated dimensions
Upstream dimensions
De jure dimensions
Concentrated dimensions
Fragile countries
Non-Fragile countries



3
2.5
2
1.5
1
0.5
0
Average score
Strategic budgeting
Formal budget preparation
Legislative budget review
Taxation
Debt
Donors
Managing cash
Procurement
Payroll
Internal control
Monitoring
Internal Audit
Accounts reconciliation
In year financial reporting
Specialized reporting
Annual financial reporting
External audit
Legislative audit review
Fragile
Non fragile