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PFM Design under Capacity Constraints

PLANNING PUBLIC FINANCIAL MANAGEMENT REFORMS IN PACIFIC ISLAND COUNTRIES

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Executive Summary

This note is intended to inform Public Financial Management (PFM) reform in small Pacific Island Countries (PICs). PFM systems in PIC contexts are often very different from the sophisticated and comprehensive systems operating in larger, wealthier countries. Those working on PFM reform in such contexts must grapple with difficult questions: What needs to be done, when achieving across-the-board "good practice" standards is not feasible? What should be done immediately, and what can wait? How can reforms be effectively implemented and sustained with limited available capacity and financial resources? This guidance note is intended to help Government officials and donor agencies answer such questions.

Our start point is that creative approaches are sometimes needed to PFM reform in Pacific Countries because of the extent and duration of capacity constraints. We have two key messages. Firstly, PFM capacity should be prioritized to areas that matter most in achieving development outcomes, and reforms should be intended to address specific, identified, problems, rather than to achieve blueprint "good practice" standards. Secondly, with small numbers of staff and high staff turnover limiting potential for sustainable gains from standard capacity building solutions (such as training programs and workshops), broader options for meeting capacity gaps should be considered, including accessing ongoing support for specialized tasks or even the wholesale "outsourcing" of certain functions.

The three main sections of this note are summarized below. Based on experiences from the region, these sections discuss: i) how to plan PFM reforms, including through the development of PFM roadmaps; ii) how to prioritize limited PFM reform capacity to address the most pressing constraints to development; and iii) how to access additional capacity to implement and sustain required PFM reforms.

Planning PFM Reforms

Plan carefully. Careful planning of PFM reforms can help build ownership and political support while ensuring available resources are put to the best possible use. Because of interdependencies between different PFM functions and processes, planning for reforms can also be technically complex. Adequate planning is especially important in the context of severe capacity constraints. A "PFM Roadmap" has become a common document for planning of PFM reforms in PICs. Drawing on analysis of weaknesses and strengths provided by a Public Expenditure and Financial Accountability (PEFA) assessment, the Roadmap aims to outline sequenced and prioritized actions to address specific PFM weaknesses, based on a realistic assessment of available capacity and resources.

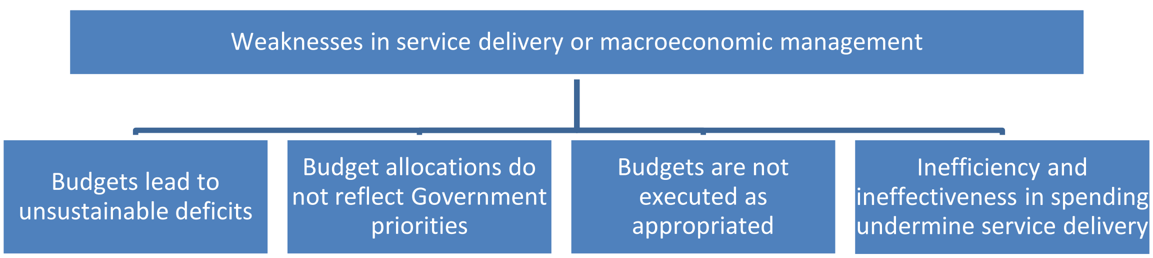
Identify goals and explain how and when they will be achieved. A good PFM Roadmap should explain: i) which PFM reforms will be prioritized and why; ii) what capacity gaps exist and how these will be addressed; iii) who will be responsible for various actions; and iv) what outcomes are to be achieved through planned reforms and by when. Medium-term time horizons are required to achieve progress and accountability for results, but flexibility is also needed to respond to changes in circumstances of policy priorities. An appropriate balance can be achieved through scheduled periodic revisions of the Roadmap document.

Discuss the plan widely and for an adequate period of time to build political support. Planning PFM reform involves allocation of resources, work, and responsibility. PFM reforms, themselves, may have impacts that are not in the interests of all parties involved. Planning PFM reform is therefore an inevitably political process. Sufficient time needs to be allocated to dialogue with a broad range of stakeholders (senior officials, Cabinet members, and members of parliament), in order to build broad ownership and political support for planned reforms and to ensure that all technical details have been considered.

Prioritizing PFM Reforms

Prioritize PFM reforms that will improve development outcomes. PFM reform is a means to improved development outcomes, rather than an end in itself. While a PEFA Assessment can help identify strengths and weaknesses in PFM systems, it does not provide an adequate basis for prioritization. Prioritization based solely on PEFA scores is not useful because: i) it is likely to be impossible to achieve high scores in all areas, given the seriousness of capacity constraints; and ii) low PEFA scores in some areas may have little relevance to the development outcomes that the government is targeting. Rather, prioritization should be guided by identification of the PFM reforms that are likely to have the greatest impact in achieving development objectives and policy goals, such as improved macroeconomic management and better health and education. Development priorities will vary according to country context, and PFM priorities will therefore also vary across countries.

Figure: Four common development challenges facing PICs



Identify the links between development challenges and specific PFM weaknesses and focus reforms on addressing those weaknesses. It is useful to clearly identify the outcome-level problem that needs to be addressed through PFM reform, and then consider the specific weaknesses in PFM systems that are contributing to that problem, and the particular reforms that would see those weaknesses addressed. The Figure above illustrates four common PFM-related development challenges facing PICs. The table on the following page shows how these challenges can be linked to PFM weaknesses and specific reforms to address weaknesses (a significantly expanded version of this table is presented in section II of the note). Applying this framework, PFM practitioners can begin with the broad problem they wish to address and then identify a small number of specific reforms that might address that problem. This framework is necessarily simplified and indicative, and should therefore be adapted and modified. But it provides a problem-based conceptual methodology for prioritizing PFM reforms that can be applied in many circumstances.

Table: Linking development challenges to possible PFM weaknesses and priority reforms

	Secondary problem	PFM weakness causing the problem	Priority reform to address the problem
Budgets lead to unsustainable deficits	• Revenue falls short of forecasts	• Revenue forecasts are unrealistic	• Improve forecasts
	• Revenue forecasts are adequate, but expenditure exceeds sustainable levels	• Upcoming expenditure obligations are not reflected in the budget	• Improve tracking and budgeting for possible liabilities and pressures
		• Allocations are increased to finance new discretionary programs during the year	• Improve transparency and justification of expenditure decisions, and build buy-in to the budget
		• Inadequate controls to prevent aggregate expenditure exceeding allocations	• Ensure controls are appropriate and enforced
Budget allocations do not reflect Government priorities	• Plans are inadequate to inform budget development	• Plans are not prepared, or have weak ownership or do not provide a realistic basis for prioritizing resources	• Improve quality of plans and build ownership through consultation
	• Plans are adequate, but not reflected in budgets	• Administrative problems impede integration of planning and budgeting	• Alignment of budgeting and planning, through shared staff, timelines, and documents
		• The Executive and Parliament have inadequate opportunity to ensure that their priorities are reflected in budgets	• Strengthen processes for Cabinet and Parliament oversight of budget formation and execution
		• There is insufficient flexibility in the budget to give effect to plans	• Provide executive with sufficient information to make substantial reallocation decisions
Budgets are not executed as appropriated	• Cash flow problems disrupt execution	• Expected cash is not available to the Ministry of Finance	• Improve revenue forecasting and build cash reserves
		• Information on line ministry cash needs is inadequate	• Improve forecasting of cash needs and information on flows
		• Additional expenditure during the year forces cash rationing	• Improve processes for authorization and financing of new spending
	• Ministries reallocate resources away from allocations	• Expenditure controls are inadequate, unsuitable, or not enforced	• Improve expenditure controls
	• Allocations are changed throughout the year to meet in-year pressures	• Inadequate allocations to anticipated in-year expenditure pressures	• Ensure anticipated pressures are budgeted for
Inefficiency and ineffectiveness in spending	• Inadequate systems to ensure good-quality spending	• Weak internal controls lead to low-quality inputs and waste	• Improve the quality of controls
		• Systems provide excessive or inadequate flexibility in input mix	• Achieve balance between control and flexibility in budget systems
	• Inadequate transparency and oversight of spending decisions	• Insufficient information is available to Cabinet and Parliament	• Improve quality and dissemination of budget and service delivery information
		• Available information is not being used	• Ensure processes encourage use of available information by Cabinet and Parliament

Accept that performance in some PFM areas will lag. PFM reforms, especially those involving changes to established processes and systems, are notoriously effort-intensive and time-consuming. Limited resources and capacity mean that the scope of achievable reforms will be constrained and prioritization across possible PFM reforms is necessary. Achieving improvements in all areas where PEFA scores are low is neither possible nor appropriate and targeting effort at specific areas is necessary. A valuable outcome of good planning processes is clarity regarding areas where reforms will not be pursued.

Accessing Capacity for PFM Reforms

Look beyond capacity building. Shortage of staff with required technical skills is one of the primary constraints to PFM reform in PICs. ***Capacity building*** is commonly cited as a means to address capacity constraints. It involves training and education of existing staff so that they can successfully complete a broader range of tasks and roles on an ongoing basis. But other options also exist and are in common use. ***Capacity supplementation*** involves provision of continuing support to staff undertaking certain functions, delivered through advisors, regional institutions, internship schemes, and regional professional bodies. ***Capacity substitution*** involves "outsourcing" of specific PFM functions on a long-term basis, with external specialist individuals or agencies performing line functions on a long-term or permanent basis. A heavier emphasis on capacity supplementation and capacity substitution may be appropriate in PIC contexts, given the extent of capacity constraints arising from small populations and the high turnover of skilled staff.

Address capacity gaps in a way that is appropriate to context. The following table summarizes the potential benefits and necessary conditions for successful implementation of each model.

	Possible benefits	Necessary conditions
Capacity Building	• Local capacity is under the direct control of the government, which is important for some sovereign state functions • If local capacity can be sustainably developed, this often represents the lowest-cost option, avoiding travel costs and international fee rates associated with other alternatives.	• Absence of staff with easily-acquired skills must represent the primary constraint to desired reforms, rather than low staff numbers or absence of highly-trained specialists • Capacity can only be built if there are adequate numbers of staff with a necessary base of knowledge and skills, and with sufficient time available for further training • Some certainty is required that staff involved in capacity development will not be rotated out of current roles or leave the public service upon completion of training.

Capacity Supplementation	• Enables quick deployment of specialised technical skills, which may not be available locally, to perform important tasks or support reform processes.	• Adequate resources are required, either from Government or donors, given that TA is often expensive • Arrangements need to ensure sustainability, either through certainty that required resources will be available for continued TA assistance, or by ensuring that there is adequate transfer of skills to allow local staff to continue the function once TA is complete • Ownership and demand for the service being provided must rest with local officials • Necessary oversight and monitoring needs to be in place, through government or donors, to ensure that TA is providing appropriate advice and assistance.
Capacity Substitution	• Provides access to skills and expertise that would not otherwise be available • Ensures that skills can be accessed when necessary, while avoiding the potentially large costs of building these capacities internally • Can create opportunities for improved quality, through contracts that emphasize performance and results.	• Political ownership and support is an important pre-condition, as there may be concerns about loss of control or opportunities for patronage or rent seeking • Adequate resources to finance outsourcing, from Government or donors, need to be identified over the long-term to avoid disruptions in functions due to financing constraints • Sufficient local capacity is required to manage an outsourcing process, including procurement and contract management.

Seek transparency when choosing between options, and ensure reporting and accountability arrangements are appropriate for the selected option. Often, advisors formally engaged in capacity building roles find themselves undertaking capacity supplementation and capacity substitution. Such non-transparent arrangements lead to inadequate accountability and inappropriate reporting arrangements. Greater transparency at the outset regarding the roles of advisors and the expected outcomes of support can ensure: increased accountability; more appropriate management and reporting arrangements; and stronger ownership.

Consider the potential role of regional institutions in meeting capacity needs. Regional solutions can provide opportunities for economies of scale in capacity building and supplementation. The Pacific has extensive experience with regional approaches. Regional solutions can offers important opportunities to reduce the disadvantages of smallness through economies of scale, provide a higher level of services at less total cost, with fewer facilities, greater efficiency, and a higher degree of shared knowledge. These opportunities are now beginning to be explored and realized in relation to PFM.

Contents

Appendices:

Introduction

This note provides guidance on planning, prioritizing, and accessing appropriate capacity for Public Financial Management (PFM) reform in Pacific Island Countries (PICs).[1] It is intended for use by Government officials, donor agencies, and consultants. It complements, and is consistent with, extensive previous work carried out by the Pacific Financial Technical Assistance Center (PFTAC) and joint efforts by the PEFA Secretariat, International Monetary Fund (IMF), and European Commission (see Box 1). Recommendations are based on a review of the literature and experiences of PFM reform in the region to date, with a focus on issues that are of particular relevance in PICs. The structure of this note is outlined in the following table.

Section	Content
1. Developing a PFM Roadmap	PFM reforms need to be carefully planned. This section outlines lessons from regional experience regarding appropriate processes for planning PFM reforms, and the important role of PFM Roadmaps in identifying and communicating PFM reform priorities.
2. Prioritizing PFM Reforms	Prioritization of PFM reforms is vital in the context of capacity and resource constraints experienced by PICs. This section provides a framework for prioritizing PFM reform capacity to address common PFM challenges that often undermine macroeconomic stability and service delivery in PICs.
3. Accessing capacity for PFM Reforms	Implementation of PFM reforms requires adequate capacity, which is often a particular challenge in PICs. This section outlines a broad range of options for accessing necessary capacity available to PICs, including regional provision and contracting out to the private sector, and provides a framework for selecting the most appropriate option.

PICs face particular challenges to PFM reform. Along with all of the challenges faced by larger countries in implementing PFM reforms, most PICs face additional important and well-known challenges due to small populations. With limited pools of human resources, a small number of public servants, and important weaknesses in institutions providing secondary and tertiary education, PICs are often unable to access the skills required for some specialized PFM functions from local labor markets. Often, there are simply too few people to complete all of the functions required in a full PFM system, with available staff stretched across a wide range of functions. The public sector in PICs also faces strong competition for human resources from the local private sector, donors, and NGOs, both locally and overseas. Capacity building efforts are often undermined, as staff with newly acquired skills and qualifications move to new roles in or outside of the public service. While many countries face capacity constraints in PFM, evidence suggests that these constraints are particularly severe in small countries, and exert a significant negative influence on PFM performance in PICs (see Box 2). While larger countries may be

[1] This Guidance Note has been specifically developed for those Pacific Island Countries with populations of less than one million. While the recommendations and conclusions may be most relevant for the smaller of the Pacific Island Countries, they may be equally valid in other countries internationally where sustained capacity constraints impact on PFM reforms.

able to build capacity to fill capacity gaps over time, capacity constraints arising from small populations sizes are likely to be longer-term, with capacity-building efforts not always a sufficient solution.

Capacity constraints are not always reflected in the design of PFM reforms in the Pacific. Common practice in PICs is to develop PFM reform plans or "roadmaps" based on standardized assessments of PFM systems under the Public Expenditure and Financial Accountability (PEFA) framework (See Appendix 1). One of the most important challenges facing PICs is to identify the relative priorities for PFM reform, when a PEFA assessment may identify more PFM weaknesses than can realistically be addressed.[2] Donors and consultants have sometimes encouraged PICs to implement systems that are used in far larger countries without regard to differences in available capacity. While existing literature and guidance highlight the need for prioritization of reform efforts, PICs have often been encouraged to achieve progress across a broad range of PFM reforms regardless of the extent to which problems in these areas are constraining the achievement of development objectives. Such broad and ambitious reform efforts are often not only ineffective in supporting sustainable improved PFM performance, but can actually harm existing PFM systems by diverting scarce PFM capacity away from areas that are more important for service delivery and macroeconomic stability.

PFM reform processes need to fit Pacific realities. This guidance note has been developed to ensure that PFM reform processes better fit Pacific realities and the development priorities of PICs. Taking account of inevitable resource and capacity constraints, this note emphasizes the need for:

- **Tight prioritization of reform efforts.** Capacity constraints mean that PICs cannot implement all of the functions assessed under the PEFA framework or expected of PFM systems in larger countries. PICs therefore need to target available capacity to improving PFM functions that are likely to have the greatest development impact, even if this means continued poor PEFA scores in some areas that are of lower priority.
- **"Good enough" rather than "best practice" solutions.** Even in areas that are priorities for PICs, implementation of systems of the same type as used in larger countries may not be appropriate. Establishing processes that achieve desired results and address the key risks is more important than implementing processes that resemble those used in larger countries.
- **A broad range of approaches to addressing capacity-constraints.** Capacity-building efforts have been the standard solution to capacity constraints in PICs for many years. These approaches have met with uneven success, however, because of high staff rotation, emigration of skilled staff, and fundamental constraints to the number of specialized tasks that can be performed by a small number of public servants. Alternative approaches to meeting capacity gaps include: i) drawing on regional facilities for capacity supplementation in vital areas; and ii) contracting of certain specialized PFM functions to private sector providers (including through the use of long-term technical assistance). If appropriately designed and implemented, these approaches – in some circumstances – can be more sustainable than attempts to build local capacity.

Appropriate approaches to PFM reform will vary by country and circumstance. This note is not intended to provide a prescriptive blueprint for designing and implementing PFM reforms. Rather, it is

[2] The Public Expenditure and Financial Accountability (PEFA) Assessment has become a standard mechanism for assessing the quality of PFM systems globally and in the region. Appendix 1 provides an overview of the PEFA framework.

intended to share recent lessons regarding approaches that have promise in achieving sustainable gains, and that take account of particular challenges faced by PICs.

Box 1: Recent Literature on PFM Reform and Sequencing

An extensive literature exists regarding the appropriate content and sequencing of PFM reforms, institutional reform, and capacity building. This note draws heavily on available literature and the recommendations presented here are generally consistent with consensus findings emerging from earlier work. Such findings include the need for government ownership, adequate planning, long time horizons for reform implementation, and consideration of political-economy factors in reform planning.

This note adds to existing work by: i) bringing together findings relating to PFM prioritization, planning, and capacity development; and ii) applying a problem-driven approach to prioritization of PFM reforms in contexts where small populations and small numbers of civil servants impose fundamental constraints on available capacity and the breadth of achievable reforms, even over the longer-term.

Key recent publications that have informed the recommendations of this note include:

- A Public Financial Management Roadmap for Forum Island Countries, PFTAC/IMF, July, 2010.
- Update on Public Financial Management Roadmap Implementation, Forum Secretariat and PFTAC, July 2012.
- Welham, B., Krause, P., and Hedger, E. (2013) Linking PFM Dimensions to Development Priorities, Overseas Development Institute Working Paper, ODI, London.
- Diamond, J. (2013) Good Practice Note on Sequencing Public Financial Management (PFM) Reforms, PEFA Secretariat.
- Diamond, J. (2013) Background Paper 1: Guidelines for Sequencing PFM Reforms, PEFA Secretariat.
- Tommasi, D., (2013) Background Paper 2: The Core PFM Functions and PEFA Performance Indicators, PEFA Secretariat.

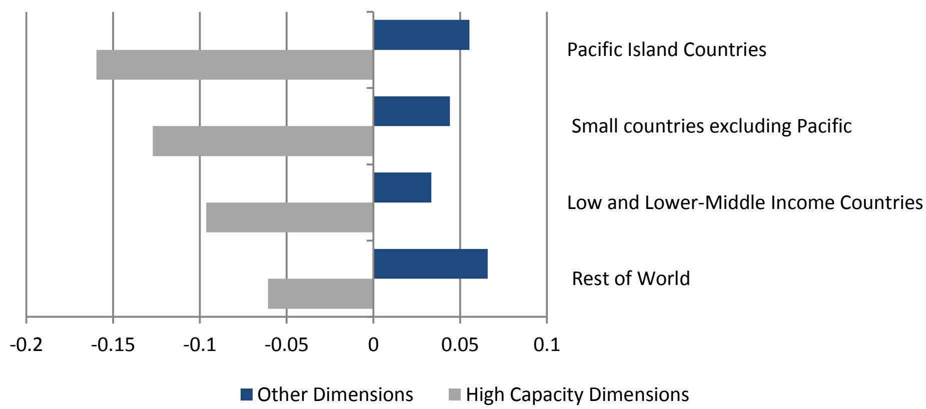
Box 2: Capacity constraints and PFM performance in small PICs

Recent research suggests that small countries face some particular disadvantages in achieving high PEFA scores. Using data from all PEFA assessments undertaken to date, population size has been shown to influence PEFA performance, with smaller countries typically performing less well when differences in income are taken into account.

The capacity constraints associated with small populations are the likely cause of this relationship. Small countries have smaller public services, in absolute terms, and a more limited pool of human resources to draw on when trying to fulfil key PFM functions. Cross country evidence shows that smaller countries lag larger countries most substantially in their performance against PEFA dimensions requiring the application of specialized capacity (such as specialist accounting, policy, budgeting, tax inspection, or forecasting skills). And this lag is greater still against PEFA dimensions that require the application of specialized skills in line agencies, where technical assistance to PFM is less common and capacity constraints are often more severe.

The following chart shows differences between average scores for high capacity dimensions and other dimensions, compared to each country's own average score for various country groups (PEFA values are converted to numeric values, with a value of 1 being equivalent to the difference between a 'D' and a 'C' score). While performance against high-capacity dimensions lags for all countries, the difference for PICs is more pronounced than the lag for the average low or lower-middle income country, and substantially more pronounced than the global average.

Figure 1: Difference from own average score by capacity type – small PICs and comparator groups



It is important to note that a wide range of factors impact on PFM performance, with country size explaining only a small proportion of observed differences in PEFA scores between countries. These results therefore do not mean that implementing effective PFM systems is impossible for small countries. Rather, they suggest that small countries may be more heavily impacted by capacity constraints when trying to undertake every function measured in a PEFA assessment. It is therefore particularly important for small countries to tightly prioritize staff and resources towards those functions that will have the greatest impact on development outcomes. Small countries may also need to consider a broader range of options to access the technical capacities required for implementing PFM reforms and carrying out core PFM processes.

Source: Haque, T., D. Knight, and D. Jayasuriya (2012) 'Capacity Constraints and Public Financial Management in Small Pacific Island Countries' World Bank Policy Research Working Paper, World Bank, Washington DC.

1. Planning PFM Reforms

This section provides an overview of "good practice" in planning PFM reforms. Experience in the region has shown that careful planning of PFM reforms is vital to sustainable gains, given the importance of making the best possible use of scarce capacity. Development of "PFM Roadmaps" has emerged as a common approach to planning and sequencing PFM reforms in PICs, and one that has been endorsed as "good practice" by relevant regional agencies and PIC governments. A PFM Roadmap is a comprehensive document outlining plans for PFM reforms. Drawing on analysis of the PFM weaknesses and strengths provided by a PEFA assessment, the PFM Roadmap outlines sequenced and prioritized actions to address specific PFM weaknesses, based on a realistic assessment of available capacity and resources. Drawing on recent literature and regional experience, this section outlines: i) the functions that a PFM Roadmap plays; ii) good practices in PFM Roadmap development; and iii) an indicative methodology for PFM Roadmap development.[3]

1.1. Functions of a PFM Roadmap

PFM Roadmaps are used to convert a PEFA assessment and other analytical inputs into a PFM reform process. They outline a realistic list of specific, prioritized, and sequenced PFM activities to be undertaken over a given period. They identify the expected improvements in PFM systems that will result from reforms, and assign responsibility for undertaking these reforms to specific teams or agencies. A good roadmap will provide a framework for monitoring progress, and a tool with which to communicate and build consensus around PFM reform plans. The functions fulfilled by a PFM roadmap development process are shown in the following table:

Function	Explanation
Prioritization of PFM reforms and communication of priorities	PEFA assessments often identify more PFM weaknesses than can be feasibly resolved with available capacity and resources. Prioritization between various possible reforms to address various weaknesses is therefore necessary. An important role for the PFM Roadmap is to identify both the weaknesses that will be addressed and (explicitly or by implication) those that will not, taking account of available resources and capacity. This is necessary, if reform plans are to be realistic. Explicit prioritization can also help manage expectations and ensure that external assistance is targeted towards actions that are likely to have the greatest development impact. The second section of this guidance note is devoted entirely to prioritization within PFM Roadmaps.

[3] Appendix 4 summarizes recent guidance from the PEFA Secretariat on planning PFM reforms.

Identification of capacity gaps and approach to addressing these gaps	PFM reforms can impose temporary capacity constraints on government ministries as reforms are implemented, but also involve longer-term changes in the skills and amounts of staffing time required to complete new or improved PFM functions. A PFM Roadmap will take account of existing capacity constraints and identify both: i) capacity gaps that will need to be filled; and ii) appropriate approaches to filling these gaps. The third section of this guidance note is devoted entirely to addressing capacity gaps for PFM reform in PICs.
Identification of targets and timelines for monitoring progress and evaluating success	A PFM Roadmap can provide a framework for assessing progress in implementing PFM reforms. This can be important for internal and external audiences, and to justify resources for PFM reform efforts. By identifying explicit and time-bound objectives to be achieved through PFM reform efforts, governments can demonstrate progress or identify problems with reform implementation. In the absence of a PFM Roadmap, external audiences – especially – can be tempted to monitor PFM progress solely through PEFA assessments, which can be problematic for several reasons (See Box 3).

PEFA Assessments alone do not provide an adequate basis for planning PFM reforms. PEFA assessments are often the starting point for PFM reform programs in PICs. PEFA assessments are seen by governments as a useful tool for informing PFM reform efforts, and are often encouraged by donors concerned with the quality of public spending and management of fiduciary risks. On their own, however, PEFA assessments provide an incomplete basis for reform programs. While the PEFA provides an assessment of a country's PFM system, it does not provide information as to: i) priorities for PFM reforms, when there are typically many "low" PEFA scores; ii) appropriate sequencing of PFM reforms, given that progress in one area of PFM is often dependent on progress in another; iii) specific actions needed to address underlying causes of PFM weaknesses, including capacity-development or supplementation requirements; and iv) limits to the extent of possible reform arising from capacity and resource constraints. Attempting to simultaneously address every low score in a PEFA assessment is unlikely to be feasible, or represent an effective use of scarce resources. Countries need to carefully consider which weaknesses to address, how to address them, and which order to address them in.

Box 3: Advantages and Disadvantages of basing the PFM Roadmap on PEFA Targets

Advantages

- Including PEFA targets in the Roadmap's Action Plan can provide a specific focus (to both those implementing, and those managing or overseeing, the Roadmap) on what needs to be done for specific PFM reform activities.
- In being directly linked to PEFA scores, reform measures may be easier to monitor.

Disadvantages

- Basing the Roadmap on achieving given results on specified PEFA PFM indicators potentially ignores or distorts government's own priorities for PFM reform (which may be different). This may lead some important reforms to be excluded from the Roadmap. It may also lead to a focus on the relatively "easier" PEFA indicators ("low-hanging fruit"), which may not address important systemic issues.
- The goal PEFA scores set out in the Roadmap may be unrealistic, either in the time period envisaged or as goals in themselves. Evidence suggests that in many countries the highest scores (A or B) for many indicators may be unrealistic even in the long term. If such scores are set as goals in the Roadmap but subsequently not achieved, this may undermine confidence in the Roadmap process.
- Since PEFA does not assess the root-causes of PFM weaknesses, the goal PEFA scores are often set without adequate analysis of the amount of resources (including management of institutional change) required to go from the current score to the desired score. Consequently, the Roadmap's desired score may be unrealistic in terms of the amount of resources available.

1.2. Good practices in PFM Roadmap development

Experiences with PFM Roadmaps in the Pacific region provide important lessons regarding the Roadmap development process. The process that is used to develop a PFM Reform Roadmap can be critical. A good process can ensure that goals are realistic, appropriate priorities for reform are identified, and that planned reforms have the support of internal and external stakeholders. Experience in PICs has led practitioners to recommend the following good practices:

- **Taking account of the political context.** Planning PFM reforms is not just a technical process. Planning PFM reform involves allocation of resources, work, and responsibility. PFM reforms, once implemented, may have impacts that are not in the interests of all parties involved. Planning PFM reform is therefore an inevitably political process. Plans that do not take account of the interests of key stakeholders are unlikely to be implemented. At all stages, planning processes should: i) take account of potential sources of political opposition; ii) allow space for discussion and contest over reform priorities; and iii) build broad ownership and political support for planned reforms.

- **Allocating sufficient time and resources.** The same capacity constraints that impede the functioning of PFM systems can also impede the planning of PFM reforms. Investing the time and effort of available staff in Roadmap development can have high opportunity costs. But such investment is likely to be ultimately worthwhile, given the potential inefficiency and wastage that can arise from a poorly-designed PFM reform process. Allocation of adequate time from Ministry of Finance officials is vital, but it is also important to ensure adequate staff time is available within other central and line ministries that will be affected by or involved in reforms. Governments need to work with donors to ensure that any TA support is provided over an adequate period of time.

- **Government leadership.** A PFM Roadmap is ultimately a government document, although it may also serve some purpose in communicating with donors or external stakeholders. Government resources will be used to implement reforms, and the actions of government employees will determine their success. Government leadership of the PFM Roadmap development process is therefore vital, with government staff both making the required decisions and leading the drafting of the document. While Technical Assistance can be a useful input to this process, required levels of ownership can only be achieved if officials, in close contact with Ministers, are leading the process.

- **Ensuring extensive consultation.** Consultation is required with technical staff working in different PFM areas, senior managers overseeing these areas, and representatives of the political level. Consultation with donors, while not always necessary, can help build support for the PFM priorities identified by government and facilitate provision of required resources and technical assistance. While potentially time-consuming, this can help build ownership and consensus around the Roadmap and ensure it incorporates government's priorities for reform (See Box 5). If external consultants are used to develop a PFM roadmap, Terms of Reference should emphasize the need for close coordination with the government to ensure the Roadmap is consistent with government objectives and priorities and well understood by all key government actors. (Information on communication strategies for PFM roadmaps is provided in Appendix 3).

- **Taking a medium-term focus.** PFM reforms take time to implement. If the timeframe for the PFM Roadmap is too short, goals are unlikely to be achievable. But timeframes for implementing reforms also need to be short enough to reflect possible changes in the priorities of Government or in economic and fiscal context. They also need to be short enough to ensure that progress can be regularly assessed to ensure accountability and demonstrate results. Overall, a 3-4 year timeframe for the reform action plan is generally appropriate.

- **Building in adequate flexibility.** While planning is important to build political support and achieve efficiency in the allocation of resources, PFM priorities will change with broader economic and political circumstances. Building flexibility into plans can be important, particularly when plans span political cycles. One option is to set out a longer-term strategy (ten year) within which shorter-term, flexible, plans may be developed and implemented incrementally.

Box 4: International Experience in Planning PFM Reforms

Recently-published guidance from the PEFA Secretariat provides advice on the appropriate sequencing of reforms. Key messages from this guidance are consistent with the recommendations of this note and include:

1. Reforms should be tailored to unique country circumstances and take into account non-technical factors (including cultural and political economy factors).
2. There is no universal, off-the-shelf PFM reform program, and an incremental approach should be followed.
3. Sequencing must not be seen as a purely technical exercise and should be guided by three main PFM priorities: (i) putting in place controls to ensure minimal level of financial compliance (fiscal control); (ii), establishing mechanisms to improve fiscal stability and sustainability; and (iii) introducing systems to promote the efficiency and effectiveness in service delivery.
4. Success should be judged by improved PFM deliverables.

Source: Diamond, J. (2013), Good Practice Note on Sequencing Public Financial Management (PFM) Reforms, PEFA Secretariat.

1.3. Methodology for Roadmap development

Approaches to developing a PFM Roadmap will vary. The methodology needs to take account of available capacity and resources, existing analysis and background material, political interest, and the role to be played by technical assistance or other external stakeholders. While individual approaches will be country-specific, all should lead to an output which is based on government's own priorities and which is realistic in terms of resources available to achieve the reforms. An indicative example of the process that might be used to develop a successful PFM Roadmap in PICs is shown in the table below.

Phase	Activity	Output
Identification of objectives sought from PFM reforms	Identify the priority outcome-level goals to be achieved through PFM reforms, such as better control of unsustainable deficits, elimination of disruptive cash rationing, or better use of resources by line agencies. Prioritization of reforms is impossible without clearly specified goals.	• Prioritized list of outcome-level objectives to be achieved through PFM reform process.
Analysis of PEFA assessment and identification of cross-cutting weaknesses	Identify the PFM weaknesses, and their underlying causes, that are relevant to the achievement of identified objectives, drawing on PEFA assessments, other PFM analyses, and consultations. Identify the cross-cutting issues that might contribute to these weaknesses, such as underlying capacity shortages in relevant areas, or inadequate basic accounting systems that undermine more advanced functions.	• Prioritized list of PFM weaknesses to be addressed to achieve objectives.

Phase	Activity	Output
Identification of prior reform commitments and plans	Identify reforms that are already underway or have been irreversibly committed to. These will impact on the availability of capacity and resources to undertake additional reforms.	• List of on-going or pre-committed reforms.
Assess available capacity and identify capacity requirements	Identify the capacity and resources likely to be available to implement planned reforms. Identify the short-term and ongoing capacity and resource requirements for reforms that are already underway or already planned. Identify the short-term and ongoing capacity and resource requirements associated with various PFM reform priorities, including technical assistance and IT needs.	• List of available capacity and resources for implementing reforms • List of capacity and resource requirements for on-going and possible future reforms.
Analyze the political-economy context of planned reforms.	Identify key institutional and organizational incentives to which stakeholders at the political level, in senior management, and at donor agencies respond, and how such incentives are likely to impact implementation of reforms.	• List of factors likely to affect or hinder reform to be taken into account in reform design
Develop a short-list of reform priorities	Develop possible packages of reforms to address stated objectives, for consultation with Ministers and final decision-makers. Each option should reflect sequencing requirements and be possible with available capacity and resources, or additional resource requirements made explicit. Options should be compatible with incentives facing key decision-makers and implementers. Trade-offs in cost and impacts between packages should be clear.	• List of prioritized reform package options, clearly showing resource and capacity requirements.
Finalize reform plan	Based on final prioritization decisions develop an action plan for sequenced and prioritized reforms within available resource constraints to be implemented over a 3-4 year time horizon.	• Final PFM Roadmap.

Box 5: Consultations for PFM Roadmaps

In order to ensure government ownership of planned reforms, PFM roadmaps should be based on extensive consultations with stakeholders at both the political and technical levels. These consultations are likely to be iterative and to take considerable time (in some cases, six months or more).

It is useful to establish a Roadmap Preparation Working Group, who will guide the consultations. The following sets out an indicative communication strategy for a PFM Roadmap development process.

Who to consult:

- Technical staff in ministries of finance and in line agencies from each of the PFM areas (e.g. planning/budgeting; tax administration; budget execution; Treasury/cash management; budget recording, accounting and reporting; external scrutiny);
- Heads of ministries of finance, Public Service Commissions, and line agencies;
- Cabinet;
- Parliament (e.g. Members of Public Finance Committee and/or Public Accounts Committee);
- Donors;
- Regional Higher Education Institutions, and
- If desired, civil society.

What to consult on:

- Potential underlying causes for PFM weaknesses, including both internal and external factors, and the appropriateness of the legal framework (*technical staff and senior management*);
- Relative importance (ranking of priority PFM weaknesses to address) *(technical staff, senior management and political level)*;
- Political support for proposed PFM reforms;
- Appropriate sequencing of PFM reform measures *(technical staff, senior management and political level)*;
- Impact of cross-linkages between PFM weaknesses *(technical staff and senior management)*;
- Risks *(technical staff, senior management and political level)*;
- Capacities for implementing specific reforms and reform programme as a whole *(technical staff and senior management)*;
- Long-term strategies/feasibility of developing local capacities;
- Options for freeing up capacity by streamlining certain functions or reducing unnecessary duplication *(technical staff, senior management and political level)*; and
- Trade-offs amongst competing reform priorities, including analysis of costs and overall resource availability for reform *(technical staff, senior management and political level).*

Box 6: Good Practice in Roadmap Development

PFTAC and the Pacific Islands Forum Secretariat identified 7 major points of emerging good practice in PIC PEFA assessments and Roadmap development (See Attachment 1 for more information):

- It is important for countries to take ownership of the PEFA assessment and PFM Roadmap
- This requires time and careful planning
- Formal assessment teams should be appropriately staffed
- Consultation with donors is important
- A “low” PEFA score does not necessarily require action
- Roadmaps should be about much more than just raising PEFA scores or meeting a donor requirement
- Sound and disciplined PFM is not just a technical matter.

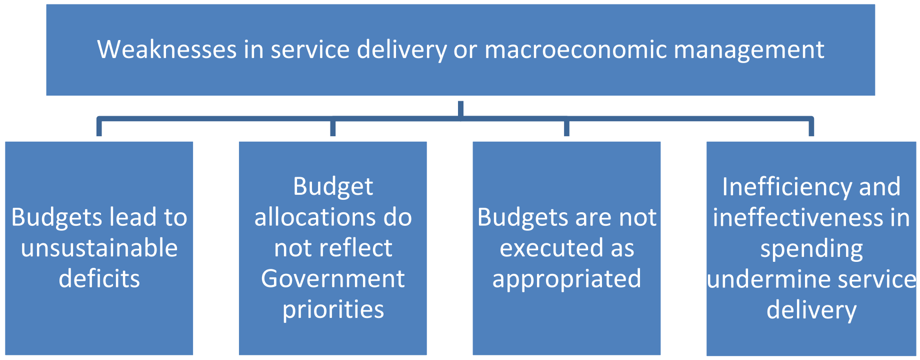
Source: Update on Public Finance Management Roadmap Implementation, Forum Secretariat and PFTAC, July 2012

2. Prioritizing PFM Reforms

This section provides a framework for prioritizing PFM reforms to address specific development challenges. One of the most important functions of a PFM Roadmap is to identify the relative priorities for PFM reform, when a PEFA assessment may identify more PFM weaknesses than can realistically be addressed. PFM reforms, especially those involving changes to established processes and systems, are notoriously effort-intensive and time-consuming. Limited resources and capacity mean that the scope of achievable reforms will be constrained and prioritization across possible PFM reforms is necessary. Due to resource constraints, not all areas of the PFM system can be improved at the same time. Recognition of these facts has led to extensive analytical work on appropriate sequencing of PFM reforms, and the approach presented here is consistent with sequencing approaches suggested by the PEFA Secretariat and the IMF.

Prioritization will inevitably be determined by a wide range of factors. Prioritization of any particular PFM reforms will inevitably involve an opportunity cost in terms of the PFM reforms that consequently cannot be pursued within resource constraints. Factors that may influence PFM reform priorities include political imperatives, the capacities of available staff, development partner requirements for budget support or project assistance, and windows of opportunity arising from particular pressures or needs. ***But prioritization should also be guided by identification of the PFM reforms that are likely to have the greatest impact in achieving development objectives and policy goals.*** This section can help in tracing linkages between common PFM challenges that undermine macroeconomic management and service delivery in PICs and the particular reforms that are most important for addressing these challenges.

The chart below shows four common PFM challenges that often undermine macroeconomic management and service delivery in PICs. The following sub-sections outline a process for determining how scarce PFM capacity can be prioritized towards addressing these common challenges. In developing a PFM Roadmap, countries can use this process to identify which of the challenges is most relevant to achieving improved development outcomes in their particular country context. From this point, countries can identify: i) the PFM reforms that could be prioritized to address a relevant challenge; ii) the specific PEFA dimensions that relate to a particular challenge and might be identified as priorities for improvement (and, by implication, those that are less relevant and where improved scores may be less important, as discussed in Box 7); and iii) gaps in the PEFA framework where reform steps may be required to address a particular challenge but are not measured by PEFA assessments.



This framework is intended to guide the prioritization process and is not prescriptive. Countries may face public finance challenges that are not described in this section. In other situations, the solutions suggested here may be impracticable or unsuitable. The framework should therefore be applied selectively and carefully. The underlying logic of the approach, however, is generally applicable when developing PFM Roadmaps. By prioritizing PFM capacity to address particular challenges that are most relevant to development outcomes, the risks associated with over-stretching available capacity can be avoided, and the probability of sustainably overcoming the identified challenge maximized.

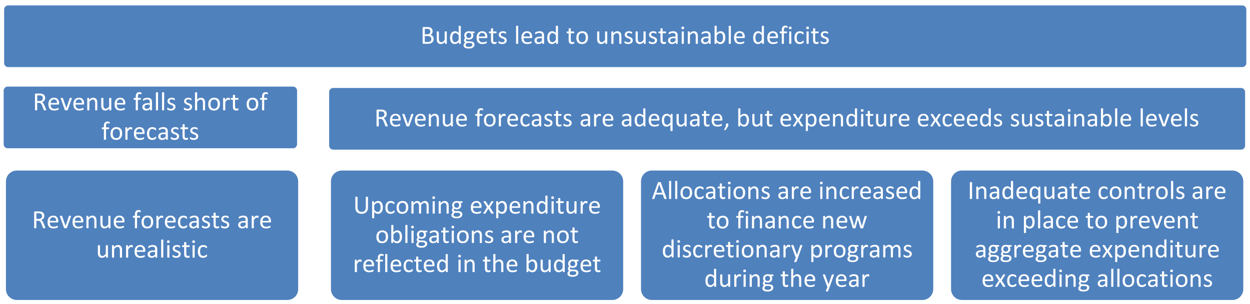
Box 7: When a "D" doesn't matter

Governments and PFM practitioners are often tempted to prioritize resources to improve their worst PEFA scores. There are a number of reasons why improving all "D" scores is an inappropriate objective:

- **Prioritization is necessary.** In common with most developing countries, PICs often have a large number of low scores. Improving PFM functions in all areas where there is a low score can be an unrealistic target, given resource and capacity constraints. Efforts to address all low scores can overload reform capacity and undermine sustainable gains. A prioritized approach may be more useful.
- **A low score is not necessarily a problem.** If the weakness of a process or system that led to a D score is not materially impacting on the ability of government to deliver services, achieve development objectives, and build transparency and accountability, the process doesn't need to be changed. It certainly should not be considered a priority for change if there are other areas of the PFM system where weaknesses are seriously undermining service delivery or achievement of development objectives.
- **A process may be beyond the control of agencies implementing PFM reforms.** Some PEFA scores assess processes that agencies responsible for PFM reforms have little influence over. For example, a country where the legislature does not typically take a strong interest in the budget process will not score highly on indicators of external scrutiny (PI-27 and PI-28), but changing the behaviour of the legislature may not be an appropriate goal for officials. This does not mean, however, that officials do not have a key role to play in providing good advice, establishing appropriate systems, encouraging consideration of available options at the political level.
- **Sequencing needs to be taken into account.** In some cases, prioritizing reforms in one area would not be cost-effective in the short- or medium-term because achieving any real gains from that improvement would require significant changes in other processes first. Examples include timely and full external audit (PI-26), which depends on timely annual financial statements being prepared (PI-25), and, in turn, accurate and timely in-year expenditure data being recorded and reported (PI-24).

2.1. Budgets lead to unsustainable deficits

PICs often face problems of macro-fiscal stability, with aggregate expenditure exceeding sustainable levels. Expenditure beyond sustainable levels leads to the accumulation of debt or the depletion of investments such as sovereign wealth funds. These problems can often be driven by: i) revenue inflows falling short of budgeted levels; or ii) expenditure exceeding budgeted levels.[4]



Revenue can fall short of forecasts because:

- **Revenue forecasts are unrealistic.** Revenue projections provide a foundation for budgeting. Budgeting in PICs is often undermined by unrealistic revenue forecasts. If macro-fiscal sustainability is being undermined by unrealistic revenue projections, countries can prioritize improvements in revenue forecasting. Sophisticated modelling is seldom needed to achieve reasonable revenue estimates. Because PIC economies, with narrow export bases and high reliance on imports, are more vulnerable to economic shocks, uncertainty is inevitable and a conservative approach to revenue forecasting is generally appropriate.

[4] We include budget support grants as a source of revenue in this framework, given the importance of such inflows for several PICs.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-3: variance between budgeted and actual revenue.** ➢ PI-12(i): preparation of multi-year fiscal forecasts ➢ D1: predictability of direct budget support (timing and amount)	**Priorities:** • The importance of predictability in donor budget support [D1] will vary depending on its share of the total budget. • PEFA provides an assessment of ex-post revenue forecasting performance [PI-3]. Governments, though, may be more concerned about avoiding revenue underperformance rather than over-performance, both of which lead to lower PEFA scores[5]. • High variance between budgeted and actual revenue may continue even with good processes, given exposure to economic volatility in PICs. Evaluating existing revenue forecasting methods might be useful when considering whether to prioritize revenue forecasting in PFM reform plans, given that variances may be the result of genuinely unforeseeable shocks. **Gaps:** • The PEFA framework does not cover processes for revenue forecasting or before-the-event assessment of revenue realism, which are vital to achieving any improved outcomes.

Expenditure may exceed sustainable levels because:

- **Upcoming expenditure obligations are not reflected in the budget.** PIC governments often have to deal with non-discretionary expenditure pressures during the year. These pressures could sometimes be foreseen if better systems were in place to record expenditure obligations and fiscal risks. Clearly foreseeable costs for utilities and other essential items are sometimes underestimated to comply with expenditure ceilings at the ministry level. Close oversight by the Ministry of Finance and comparison with previous year spending patterns can help eliminate deliberate underestimation. Further, spending obligations can arise from debt servicing requirements, realization of unrecorded contingent liabilities, the need to meet accumulated arrears, or on-going costs of policy decisions. If macro-fiscal planning is undermined by inadequate allocations for expenditure pressures and obligations, countries can prioritize improvements in systems to record and monitor these pressures and ensure that they are reflected in budgets. Genuinely unforeseeable spending pressures can also arise from natural disasters or other shocks. Ensuring adequate contingency allocations in the budget is the most appropriate means of dealing with these risks, but – with inevitably limited resources – in-year reallocation may still be needed in the context of major shocks.

[5] While less common in PICs, revenue over-performance can also cause problems if unexpected surpluses are the result of deliberate under-forecasting and used to finance expenditure outside of the budget process. In such situations, constraints to more accurate forecasting may be more political than technical.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-1: Aggregate expenditure outturn compared to original approved budget** ➢ **PI-4: management of arrears** ➢ **PI-9: oversight of fiscal risks of public entities, including state owned banks and enterprises** ➢ **PI-12(ii): scope and frequency of Debt Sustainability Analysis.** ➢ **PI-17: processes for approving, recording and reporting on loans and guarantees.** ➢ **PI-2(ii): Actual expenditure charged to contingency vote** ➢ PI-12(i): existence of multi-year fiscal forecasts ➢ PI-8: transparency of fiscal relations with sub-national government	**Priorities:** • Priority reforms will depend on whether expenditure pressures are being driven by limited understanding of debt dynamics and debt servicing costs (PI-12ii and PI-17); insufficient knowledge of fiscal risks from SOEs (PI-9); the build-up of arrears (PI-4); or genuinely unforeseeable shocks. • Countries with stable debt dynamics may be less concerned about frequency of debt sustainability analysis, which is emphasized in the PEFA framework. • While detailed multi-year fiscal forecasts or full medium-term expenditure frameworks may not be necessary (PI-12i), some mechanism for capturing significant future fiscal implications of major policy decisions is likely to be needed – this could include a basic system for recording upcoming fiscal risks and a register of high-value assets. • PI-8 is unlikely to be important for PICs, given limited fiscal decentralization. **Gaps:** • PEFA measures check the existence of systems and processes for recording future obligations, but do not assess the quality of analysis, which can be equally important.

- **Allocations are increased to finance new discretionary programs during the year.** Expenditure pressures can sometimes arise from decisions to fund new, discretionary programs outside of the budget process. The scope to manage such pressures through PFM reforms is limited. If macroeconomic sustainability is undermined by pressure from new discretionary spending, countries can prioritize systems to ensure that such decisions are being made transparently, and that the budget process allows sufficient opportunity for priority programs to be adequately financed during budget formation. Training for parliamentarians and Cabinet can be provided to ensure that their role in setting ceilings is understood and the consequences of approving additional between-budget expenditure are known.

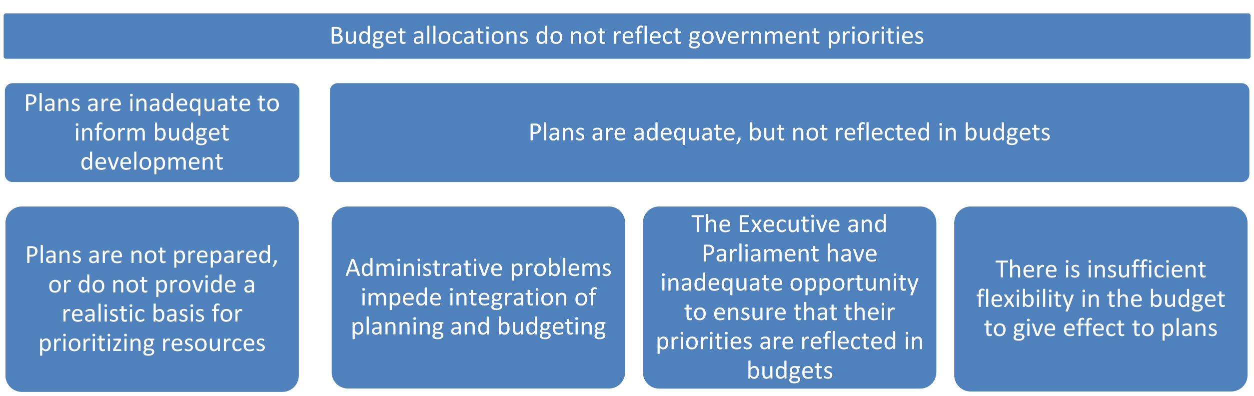
Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-1: aggregate expenditure outturn compared to original approved budget** ➢ **PI-10: public access to key fiscal information** ➢ **PI-11(iii): Cabinet setting of sector ceilings** ➢ **PI-27: legislature's review of draft budget**	**Priorities:** • Cabinet setting of sector ceilings (PI-11iii) and legislature's review of the draft budget (PI-27) can help achieve buy-in to expenditure limits. • Public access to information on revenues and expenditure can ensure that any unsustainable expenditure decisions are transparent (PI-10). **Gaps:** • The PEFA framework does not assess overall medium-term sustainability of budgets. • Quality of decisions made by policy-makers is not assessed through PEFA.

- **Inadequate controls are in place to prevent aggregate expenditure exceeding allocations.** Even with good revenue forecasts and systems to record spending obligations, macro-fiscal sustainability in PICs is sometimes undermined simply because governments end up spending more than was intended. This can occur through inadequate controls on expenditure and commitments and inadequate tracking of expenditure levels during the year. If macro-fiscal sustainability is undermined because aggregate expenditure exceeds allocations, countries can prioritize systems to exert expenditure control. Priorities for reform will depend on whether overspending is driven by payroll or other expenditure. Systems should be improved to address the cause of the overspending. For example, payroll expenditure may exceed limits because of outdated and inaccurate personnel and payroll data or because of illegitimate alteration of payroll and personnel information during the year. Other spending may exceed limits because commitment rules are inadequate or unclear, or because rules are not complied with.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-1: aggregate expenditure outturn compared to original approved budget** ➢ **PI-18: effectiveness of payroll controls** ➢ **PI-20: effectiveness of internal controls on non-salary expenditure**	**Priorities:** • PEFA dimensions relating to control are generally a high priority, but relevance of specific dimensions will depend on whether payroll or other spending is driving overspends, and whether information needs to be improved, rules and systems strengthened, or compliance enforced. • The PEFA measure captures expenditure in excess of original budget due to both changes in appropriations through the year and due to lack of expenditure control, the second of which might be a greater problem.

2.2. Budget allocations do not reflect government priorities

The effectiveness of public expenditure in PICs is often undermined by a mismatch between government policy objectives and budget allocations. Ministries' budgets do not reflect what they are expected to deliver during the year, undermining implementation, and making it more difficult to hold ministries accountable for delivery on policy objectives. Resources are expended in ways that do not align with development goals, undermining development progress. PFM weaknesses that often drive these problems include: i) inadequacy of planning processes; and ii) a failure to take account of plans when budgets are developed.



Plans may be inadequate to inform budget development because:

- **Plans are not prepared, or do not provide a realistic basis for prioritizing resources.** National development strategies, sector strategies, or ministry corporate plans in PICs are often inconsistently prepared, or contain insufficient information to inform or justify the allocation of resources through the budget. It is often unclear what agencies will deliver with resources or how much it is likely to cost. Plans often include unrealistic and unaffordable objectives. If plans are inadequate to inform the allocation of resources, developing better plans – that can guide clear prioritization decisions under realistic resource constraints – is a clear priority. But preparing exhaustive costed plans at the national, sector, and ministry level can be a major drain on limited human resources. Instead, line ministries can relatively easily prepare simple, short documents outlining activities to be undertaken, links to national development plans, and trade-offs between activities that would have to be made under different, realistic resource envelopes. These documents can be used to meet both corporate planning and budget process requirements. Central agencies have an important role to play in assisting ministries in the development of plans, avoiding overlaps and gaps in activities, and ensuring affordability within aggregate fiscal resources. This process can be facilitated if responsibility for planning and budgeting is not separated between different staff members in different teams.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-12(iii): existence of costed sector strategies**	**Priorities:** • PEFA places priority on the "full costing" of ministry/sector strategic plans. Detailed costing activities are capacity-intensive and seldom necessary to achieve the objective of prioritization between possible activities within a realistic resource constraint over a medium-term horizon. Recent research has highlighted the mixed success of medium-term expenditure frameworks in addressing such issues, especially in low capacity environments.[6] Adequate basic costing can be undertaken if responsible staff have adequate understanding of both ministry and sector plans and budgets. **Gaps:** • The PEFA measure checks the existence of and coverage of plans but does not assess the quality of plans or how well they are integrated with budgets.

Even if adequate plans are developed, plans may not be reflected in budgets because:

- **Administrative problems prevent integration of planning and budgeting.** Budgets and plans are often inconsistent in PICs because documents are prepared by different staff at different times, with insufficient contact and coordination. Plans and budgets need to be well-integrated. Plans and budgets can be prepared at the same time and with the same finance ministry staff members involved in both processes, closely liaising with line ministries. Institutional divisions between budget and planning divisions in the Ministry of Finance are sometimes an important constraint to this integration. Introduction of a single calendar for budgeting and planning processes, improved coordination between staff involved in the process, joint responsibility for planning and budgeting within the same teams, and combining budgeting and planning information into single ministry documents, can help address these problems.

[6] See World Bank (2013), 'Beyond the Annual Budget: Global Experience with Medium-Term Expenditure Frameworks', Washington, DC: World Bank. https://openknowledge.worldbank.org/handle/10986/11971

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-11(i): annual budget calendar**	**Gaps:** • Existence of multiple, inconsistent planning calendars is not addressed in the PEFA framework. • The planning and budgeting process is not adequately assessed in the PEFA framework.

- **The executive and parliament have insufficient opportunity to ensure that the budget gives effect to government priorities as expressed in plans.** In PICs, budget allocations are often weakly linked to development objectives because Cabinet and parliament have limited engagement in relevant stages of the budget process. Without strong executive and parliamentary involvement, budgeting has sometimes become a technocratic exercise involving consideration only of the cost of programs and inputs, and not linked to government priorities. Budget preparation and reporting processes can be strengthened to ensure that Cabinet sets budget ceilings, proposes a budget within this framework that reflects policy priorities, and monitors execution throughout the year. Processes can be strengthened to ensure that parliament has the opportunity to review the proposed budget for how closely it links to policy objectives.

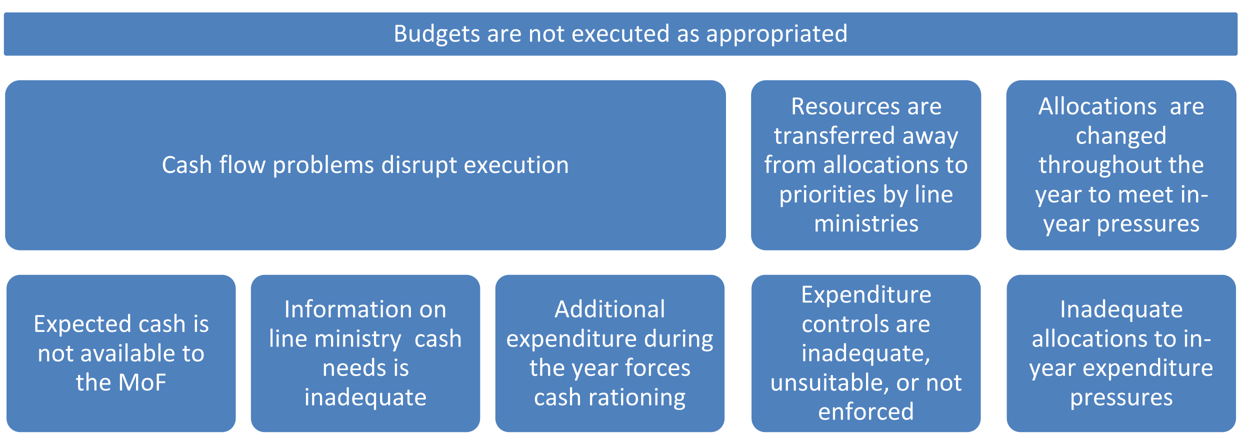
Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-11(iii): Cabinet setting of sector ceilings** ➢ **PI-27: legislature's review of draft budget** ➢ PI-28 – legislature's review of external audit reports	**Priorities:** • Legislature's review of external audit reports often focuses on fiduciary issues, and may not be relevant for improving links between policy and budgets. **Gaps:** • Cabinet's role in setting and monitoring national fiscal/ budgetary policy goals beyond setting sector ceilings not adequately covered by PEFA. • The legislature's role in monitoring the use of budgetary allocations (beyond fiduciary oversight) and actual expenditures not adequately addressed by PEFA.

- **There is insufficient flexibility in the budget to give effect to government priorities as expressed in plans.** Governments in PICs are often constrained in giving effect to policy priorities through the budget because a large proportion of spending is considered to be already "committed" to on-going activities and programs and meeting payroll or other cost increases. Ensuring that plans list ministry activities and options for changing the mix of these activities within a range of realistic expenditure envelopes would allow the executive to consider prioritization options across all expenditure, rather than focussing on allocation of often small amounts of marginal additional expenditure during the budget.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-12(iii): existence of costed sector strategies**	**Priorities:** • Sector or ministry strategies should provide sufficient information to allow informed prioritization by the executive within the envelope of recurrent expenditure available to a ministry. • Sector strategies can be simple, short documents that combine planning and budget information for a ministry and required information can simply be included in budget documentation. **Gaps:** • The PEFA measure checks the existence of and coverage of plans but does not assess the quality of plans or the alignment of expenditure with plans. • The PEFA framework does not assess payroll policies, which can lead to inflexibility in allocations of staff across ministries and significant locked-in expenditure increases which monopolize fiscal space.

2.3. Budgets are not executed as appropriated

The effectiveness of public expenditure in PICs is often undermined by large differences between the planned budget and actual resource use. Reallocation of resources leads to disruptions in service delivery. Reallocation also undermines the usefulness of the budget as a planning tool, and makes it difficult to implement policies and achieve development objectives. PFM weaknesses that often drive these problems include: i) weak cash management systems; ii) transfer of resources away from allocated areas by line ministries; and iii) changes to expenditure allocations during the year to meet in-year pressures.



Cash-flow problems can disrupt execution if:

- **Expected cash is not available to the Ministry of Finance.** Shortages of cash held by Pacific Island ministries of finance often force cash rationing, which can cause serious disruptions to service delivery. Shortfalls in expected cash to the Ministry of Finance may occur because overall revenue forecasts are inaccurate; inadequate account has been taken on unevenness in revenue receipts throughout the year; expected donor funds have not been forthcoming; or because revenue flows have been disrupted by economic shocks. If cash flow problems are arising because expected cash is not available to the Ministry of Finance, countries can prioritize improving revenue forecasts – including monthly cash revenue forecasting at the level of revenue items – and building up sufficient cash reserves to deal with external shocks.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-2: Composition of expenditure outturn compared to original approved budget** ➢ **PI-3: variance between budgeted and actual revenue.** ➢ PI-12(i): multi-year fiscal forecasts ➢ D1: Predictability of direct budget support (timing and amount)	**Priorities:** • Governments may be more concerned about avoiding revenue underperformance rather than over-performance, both of which lead to lower PEFA scores. • The importance of predictability in donor budget support [D1] will vary depending on its share of the total budget. **Gaps:** • The PEFA framework does not assess processes for revenue forecasting or before-the-event assessment of revenue realism, which are vital to achieving any improved outcomes. • The PEFA framework does not assess in-year revenue projections, which can be important for cash-flow management. • Adequacy of cash reserves is not assessed under the PEFA framework.

- **Information on line ministry cash needs is inadequate or incomplete.** Even if revenue flows to the Ministry of Finance occur as expected, cash rationing can be necessary because the cash needs of ministries have not been adequately taken into account. This problem often arises because adequate cash flow forecasts are not prepared by line ministries, regularly updated, or submitted to the Ministry of Finance. If cash-flow problems are arising due to inadequate forecasting of cash needs by spending ministries, countries can prioritise improvements in processes for: i) preparing annual cash-flow disaggregated monthly forecasts (going beyond the common practice of assuming an equal amount of cash is needed in each month of the year) and submitting these to the Ministry of Finance; ii) recording in-year expenditure by line ministries, so that actual cash needs can be monitored; and iii) reviewing cash-flow needs throughout the year, and communicating changes to the Ministry of Finance as necessary.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-16(i): extent to which cash-flows are forecast and monitored** ➢ **PI-22: timeliness and quality of accounts reconciliation** ➢ PI-24: quality and timeliness of in-year budget reports	**Priorities:** • Priorities will depend on whether problems are arising in preparation, updating, or communication of cash forecasts to Ministry of Finance, in the accuracy of these forecasts, or in the ability of MoF to track cash balances. **Gaps:** • Quality and accuracy of cash-flow forecasts is not assessed by PEFA (only the existence of such forecasts and whether they are updated).

- **Available cash is exhausted because of additional expenditure or changed priorities during the year.** In some PICs, cash rationing has been required because additional expenditure has been authorized during the year without regard to available cash. In this situation, countries can prioritize processes to ensure that: i) clear rules and transparent processes exist for new in-year spending (including clear processes and criteria for accessing the contingency fund); ii) funding sources are identified for all new spending proposals; and iii) availability of cash is taken into consideration.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ PI-11(i): existence of and adherence to a fixed budget calendar ➢ PI-2(ii): Actual expenditure charged to contingency vote ➢ PI-16(iii): frequency and transparency adjustments to budget allocations	**Priorities:** • Priorities will depend on the drivers of new in-year spending. **Gaps:** • Issues of budget policy are not addressed in the PEFA framework, such as the appropriate level of resources provided to the contingency.

Ministry expenditure may not be aligned with budgeted allocations if:

- **Controls to ensure appropriate spending are inadequate, unsuitable, or not enforced.** Budget execution is undermined in some PICs because there are inadequate controls to ensure that resources are used in ways that align with budgets. In these cases, budget allocations may reflect government priorities, but actual expenditure does not reflect allocations. Large variances between budgeted allocations and actual spending at the level of inputs and functions can undermine implementation of Government priorities and the usefulness of the budget as a planning tool. Problems can arise because: i) formal controls do not exist; ii) appropriate controls are in place, but are not enforced; or iii) controls are excessively burdensome or poorly-matched to available capacity. If budget execution is being undermined by problems with controls on expenditure, countries can prioritise the development or revision of expenditure control systems. Reforms should be aimed at ensuring expenditure is aligned with the budget without imposing unrealistic burdens on available capacity or undermining flexibility when it is necessary and appropriate.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-18: Effectiveness of payroll controls** ➢ **PI-19: Competition, value for money, and controls in procurement** ➢ **PI-20: Effectiveness of internal controls on non-salary expenditure** ➢ PI-21: Effectiveness of internal audit ➢ PI-26: scope, nature, and follow up of external audit	**Priorities:** • Priorities will depend on whether execution problems are caused by inappropriate systems or inadequate compliance with systems. • Internal audit arrangements (PI-21) are unlikely to be a priority until external audit is functioning effectively, given limited audit capacity. If required, internal audit could be developed within only the largest spending ministries. • Procurement dimensions may be a priority if poor procurement practices are driving inappropriate expenditure. • If competitive procurement processes can be put in place and compliance with these processes achieved (PI-19i and PI-19ii), countries may be less concerned about public transparency (PI-19iii), review mechanisms (PI-19i) or a complaints process (PI-19iv). **Gaps:** • Adherence to controls on wage-bill and on procurement is not sufficiently covered by PEFA.

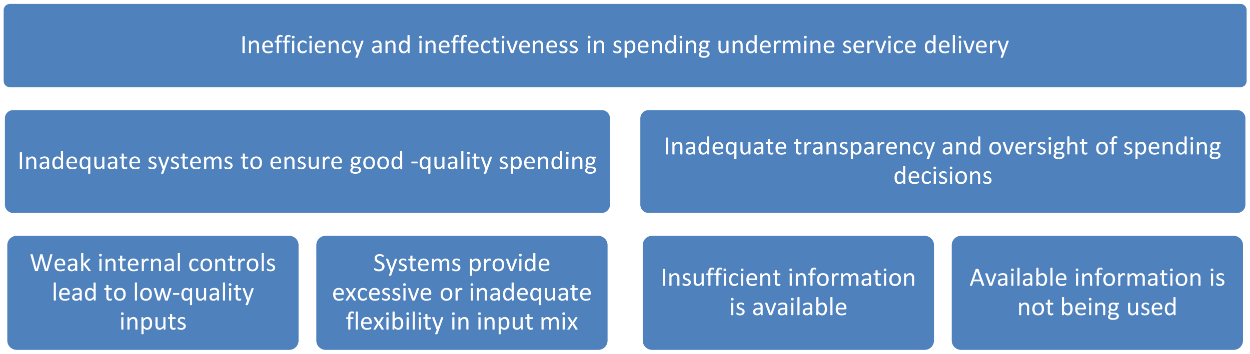
Allocations may be changed throughout the year to meet expenditure pressures because of:

- **Inadequate allocations to address expenditure pressures.** Budget execution in PICs is often undermined by reallocation of expenditure during the year as foreseeable and unforeseeable new priorities emerge. Many pressures could be foreseen and budgeted for if better systems were in place to record medium-term expenditure obligations. These spending obligations can arise from inadequately budgeted debt servicing requirements, inadequate provisioning for contingent liabilities, the need to meet accumulated arrears, or on-going costs of policy decisions. If budget execution is undermined by the need to meet foreseeable in-year expenditure pressures, countries can prioritize improvements in systems to record and monitor these pressures. Genuinely unforeseeable spending pressures can also arise from natural disasters or other shocks. Ensuring adequate contingency allocations in the budget is the most appropriate means of dealing with these risks, but – with inevitably limited resources – in-year reallocation may still be needed in the context of major shocks.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-4: management of arrears** ➢ **PI-2(ii): Actual expenditure charged to contingency vote** ➢ **PI-9: oversight of fiscal risks of public entities, including state owned banks and enterprises** ➢ **PI-12(ii): existence and frequency of Debt Sustainability Analysis.** ➢ **PI-17: processes for approving, recording and reporting on loans and guarantees.** ➢ PI-12(i): existence of multi-year fiscal forecasts ➢ PI-8: transparency of fiscal relations with sub-national government.	**Priorities:** • Priority reforms will depend on whether expenditure pressures are being driven by limited understanding of debt dynamics and debt servicing costs (PI-12ii and PI-17); insufficient knowledge of fiscal risks from SOEs (PI-9); the build-up of arrears (PI-4); or genuinely unforeseeable shocks. • Countries with stable debt dynamics may be less concerned about frequency of debt sustainability analysis, which receives specific emphasis in the PEFA framework. • While comprehensive multi-year fiscal forecasts may not be necessary (PI-12i), some mechanism for capturing significant future fiscal implications of major policy decisions is likely to be needed. • PI-8 is unlikely to be important for most PICs, given limited fiscal decentralization. **Gaps:** • PEFA measures check the existence of systems and processes for recording future obligations, but do not assess the quality of analysis, which can be equally important.

2.4. Inefficiency and ineffectiveness in spending undermine service delivery

Service delivery in PICs is sometimes undermined by poor quality spending. Public funds are often used to purchase poor-quality inputs. Inputs are purchased in combinations that are inappropriate to achieve policy priorities. PFM weaknesses that often drive these problems include: i) inadequate control measures to ensure good-quality spending; and ii) inadequate transparency and oversight of spending decisions. However, such weaknesses are often also driven by weaknesses at the line level that are not assessed in the PEFA framework and not fully amenable to being addressed through reform of central PFM systems. Policy-makers concerned about the impact of inefficiency and effectiveness of spending at the line level should consider improvement in government-wide PFM systems only one tool in a range of reform solutions.



Systems may be inadequate to ensure good-quality spending if:

- **Weak internal controls lead to low-quality inputs.** Efficiency and effectiveness of expenditure is sometimes undermined in PICs because of inappropriate controls on spending. Control systems in procurement and payroll have an important role to play in preventing inappropriate spending or deliberate misuse of funds, and in improving public perceptions regarding the integrity of systems. These systems will only be effective if compliance is enforced. But spending quality can also be undermined if very tight expenditure control systems cause bottlenecks and impede appropriate input mix at the line level. If expenditure quality is being undermined by weaknesses in control systems, countries can prioritise improvements in these systems to achieve a more appropriate balance between control and flexibility.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-18: effectiveness of payroll controls** ➢ **PI-19: competitions, value for money, and controls in procurement** ➢ **PI-20: effectiveness of internal controls for non-salary expenditure** ➢ PI-21: effectiveness of internal audit	**Priorities:** • PEFA dimensions relating to control are generally a high priority for ensuring improved quality of spending. • Internal audit arrangements (PI-21) are unlikely to be a priority, given limited audit capacity in PICs, but some key internal audit functions can be undertaken by external auditors. • Priority of procurement dimensions will depend on whether poor procurement is undermining expenditure quality. • If competitive procurement processes can be put in place and compliance with these processes achieved (PI-19i and PI-19ii), countries may be less concerned about public transparency (PI-19iii), review mechanisms (PI-19i) or a complaints process (PI-19iv). **Gaps:** • Compensation policies and contract management are vital to quality expenditure, but not covered in the PEFA framework. • Procurement processes can be undermined by constraints on supply in PICs with small economies and narrow markets but such constraints are not reflected in the PEFA framework. • Higher scores are generally given for tighter controls under the PEFA framework – avoiding procurement backlogs is an important goal that is not assessed.

- **Systems provide excessive or inadequate flexibility to line ministries in determining what they spend money on.** Efficiency and effectiveness in public expenditure is sometimes undermined in PICs by either excessive or insufficient management discretion over input mix. Inflexibility in the inputs – such as staff, equipment, or contracted services – available to ministries can lead to inefficiency, with managers often having too much of something they do not need, and not enough of something that they do. Discretion over inputs can provide important benefits, by allowing those with direct accountability and good information to decide on what is needed to deliver programs and achieve objectives. But, if excessive, such discretion can lead to poor outcomes. Discretion will only lead to better spending if there are strong incentives for delivery, good accountability systems, mechanisms for monitoring outputs or outcomes, and a performance culture. If quality of expenditure is being undermined by excessive or inadequate flexibility in input mix, countries can prioritize reforms of systems to achieve a more appropriate level of flexibility, taking account of the broader context and the extent to which managers can and will be held accountable for resource use and delivery. In most PICs, granting some discretion to line ministries over the use of inputs may be appropriate. But few countries have the accountability systems in place to grant full discretion over inputs.

There may be inadequate transparency and oversight over expenditure decisions if:

- **Insufficient information is available.** Transparency can be an important driver of efficiency and effectiveness in the use of public resources. Limited access to high-quality fiscal information may be impeding the efficient use of public resources in some PICs. Accountability to the public, parliament, and the executive relies on the availability of information, including information on policy priorities, budget allocations, debt, cash flows, future liabilities, and procurement decisions. If efficiency and effectiveness of expenditure is undermined by a lack of information, countries can prioritize: i) collection of key fiscal information by the Ministry of Finance; ii) analysis of relevant information to identify trends and patterns that may be of interest to the public or decision-makers; iii) dissemination of information in an accessible format to relevant audiences (including the executive, parliament, the public, and civil society organizations).

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-4(ii): availability of data for monitoring the stock of expenditure payment arrears** ➢ **PI-7(ii): income/expenditure information on donor-funded projects which is included in fiscal reports** ➢ **PI-9: oversight of aggregate fiscal risk from other public sector entities** ➢ **PI-10: public access to key fiscal information** ➢ **PI-19(iii): public access to complete, reliable, and timely procurement information** ➢ **PI-24: quality and timeliness of in-year budget reports** ➢ **PI-26(i)(ii): scope and nature of external audit** ➢ PI-23: availability of information on resources received by service-delivery units ➢ PI-8(iii): extent to which consolidated fiscal data is collected and reported for general government according to sectoral categories	**Priorities:** • Priorities will depend on whether increased accountability to the executive, parliament, or the public is most pressing to deliver efficiency improvements. • Disseminating information on resources received by service-delivery units (PI-23) is capacity and resource intensive, and unlikely to be an initial priority. • Provision of consolidated fiscal information across local governments (PI-8iii) is unlikely to be a priority given limited resources provided to most sub-national governments. **Gaps:** • PEFA's relative focus is on the dissemination of data to the public (PI-10, PI-19iii, and PI-23), rather than on the actual collection of data. PEFA does not address the quality of the information except in PI-24iii.

- **Available information is not being used.** Collection and dissemination of information will not lead to improved efficiency and effectiveness unless that information is used by decisions-makers to make better decisions, reward good performance, and address underperformance. In PICs, action sometimes does not occur, even when the right information is collected. While resolving this problem may be beyond the scope of a PFM reform process, countries may wish to prioritize broader engagement between the Ministry of Finance, Cabinet, Parliament, the Public Accounts Committee on budget formation and execution and various review processes (including audit). Options for direct public engagement, including through outreach to Non-Government Organizations (NGOs) and Civil Society Organizations (CSOs) could also be considered.

Relevant PEFA dimensions	Issues when considering PEFA impacts of reform priorities
➢ **PI-26(iii): follow-up of external audit** ➢ **PI-27 legislative scrutiny of the annual budget law** ➢ **PI-28: Legislative scrutiny of external audit reports**	**Priorities:** • PEFA dimensions tend to emphasise ex ante budget preparation and ex-post scrutiny rather than on-going systems for monitoring and management of execution. **Gaps:** • PEFA does not assess the role of public input in budget formation.

3. Accessing Capacity for PFM Reform

Capacity is an important constraint to implementation of PFM reforms in PICs. The introduction of new processes, systems and structures may not only place temporary additional demands on capacity, but lead to permanent changes in the skills required. PFM reform processes should involve explicit consideration of and planning for changed capacity needs. Different approaches to addressing capacity gaps might be needed in PICs, where capacity constraints are particularly pronounced. Along with traditional capacity-building approaches, consideration should also be given to accessing capacity from alternative sources, such as international technical assistance, use of regional institutions, or long-term contracting of firms and individuals with required skills.

There is no single solution to capacity needs. Rather, consideration should be given to what will work best in the circumstances. This section provides: i) an overview of options available to meet capacity gaps when implementing PFM reforms; ii) a framework for choosing between these options; and iii) a description of the risks associated with different capacity options and ways in which these can be mitigated.

Box 8: What is capacity?

In a general sense, capacity includes the skills and aptitudes, resources, relationships, and facilitating conditions necessary to effectively achieve an intended purpose. "Capacity" operates at three levels:

- Individual capacity: the skills, knowledge and experience of individuals with PFM roles and responsibilities
- Organizational capacity: structures, processes, systems and resources required for a functional PFM system. This will extend across the organizations of central government, including sub-national organizations, State Owned Enterprises, and various authorities
- The enabling environment: enforceable rules and legal, regulatory, and policy frameworks; political support for reform initiatives; understanding of the importance of PFM across government and among political leaders; education infrastructure to support the development of required capacities.

Each of these levels of capacity is interconnected and interdependent. Because of the linkages among the levels, efforts to strengthen one level without paying attention to the other two generally lead to limited and/or unsustainable results. Core requirements for achieving sustainable capacity are summarized in Appendix 5.

3.1. Options for Meeting Capacity Gaps

Countries with small populations face particular challenges in building local capacity, even over a longer timeframe. Consideration should be given to the full range of possible approaches to addressing capacity needs. Options are summarized in the following table and explained in more detail below.

Approach	Description
Capacity Building	• Through training and education, staff acquire new skills to successfully undertake a broader range of PFM functions.
Capacity Supplementation	• PFM improvements are supported by external advice and assistance, but responsibility for delivery remains with local agencies and staff.
Capacity Substitution	• Responsibility for delivery of improved PFM functions is "outsourced" to external providers.

Capacity Building

Capacity building is typically a core element of a PFM roadmap. Capacity building involves sustainably expanding the range of tasks and processes that can be successfully completed by existing staff. This would normally involve workshops, training by local and regional training institutions, and on-the-job training from technical advisors.

Capacity building is widely applied in Pacific contexts. Examples include workshops and training provided by multilateral and bilateral donors or Australian and New Zealand agencies, and provision of short-term advisors in specific capacity-building roles.

Capacity Supplementation

Capacity supplementation involves filling advisory functions using personnel outside the usual civil-service structure. The objective is the gradual accumulation of new skills through real-time practical advice. Officials with PFM responsibilities are provided with various forms of assistance, but they remain responsible for successfully completing tasks and functions. Technical assistance could be considered as supplementary, provided that it is clearly advisory in nature and does not start to assume or substitute for civil servant responsibilities.

Capacity supplementation can be achieved through a range of different approaches, including:

- **Formal 'twinning' or backstopping arrangements.** Such arrangements can be established between ministries in countries that have requisite skills and experience (developed or developing) and equivalent ministries in PICs undertaking PFM reforms. This can allow a dependable source of assistance from individuals with relevant technical experience and the development of personal relationships between staff fulfilling similar roles in different countries.

- **Salary top ups for civil servants.** Top ups can allow ministries responsible for PFM reforms to recruit and retain able individuals in key PFM advisory roles when these individuals might otherwise relocate overseas or move out of government.
- **International technical advisers.** Advisors recruited globally or from neighbouring countries facing similar issues can be placed in supporting roles within ministries responsible for PFM reforms and functions.
- **Training of graduates through internship schemes**. This can offer a clearer and more comprehensive career path for recent graduates, starting at junior levels with the prospect of rapid advancement.
- **Confidential high-level advice to Ministers and senior figures**. Given the importance of political will in driving PFM reforms, donors can finance special advisers to Ministers and senior officials engaged in PFM reform. These can be chosen by the Minister or senior officials responsible, rather than the donor, and their advice should be confidential.

Technical advisors in PICs typically play a capacity supplementation role, with responsibility for both advising on new systems and processes and building the capacity of local staff to make these improvements sustainable without ongoing assistance. Responsibility for carrying out tasks and functions typically remains with officials, but assistance is provided in completing particular specialized or labour-intensive functions as capacity is developed.

Examples of Capacity Supplementation:

- Support from donor-financed advisors to a new corporate planning approach in Tonga, where specialist technical advice is provided by an international TA, but with Ministry of Finance staff responsible for delivery.
- Technical advisers on PFM reform working on Malawi’s Government Financial and Economic Management reform program, with resident advisers performing permanent advisory roles located in the Ministry.

Capacity Substitution

Capacity substitution involves the use of external specialists filling line positions (not an advisory role) in government agencies. It includes outsourcing of an activity or function from the government to an external agent, whether private or non-profit. The objective is to rapidly install additional capability to carry out targeted functions that require external support. This can involve:

- **Outsourcing of discrete functions to the private sector**. Certain offices and functions, for example the audit function, could be supplied by the private sector and funded by donors.
- **Long-term technical advisors in in-line roles.** Donor-funded advisors can take the place of staff if there is no realistic prospect of these roles being adequately filled with local capacity.
- **Donor delivery of some parts of the government’s PFM work for the foreseeable future.** Recognising the frequent failure of more advanced PFM reforms (e.g. MTEFs and programme-based

budgeting) in low-capacity environments, certain functions that are regularly carried out by donors as part of their regular work can substitute for such PFM services. For example, IMF Article IV consultations undertaken closely with government and modified slightly could provide a basic MTFF to guide expenditure over the medium term. The World Bank can provide some of government's long-term economic thinking through its Economic and Sector advisory work that can effectively substitute for a lack of government capability in these areas.

Capacity substitution can ensure that adequate capacity is available to implement PFM reforms and functions even in environments where required capacity is not otherwise available. Responsibility for delivery is "outsourced", but delivery agents remain accountable to government. While capacity of officials is not necessarily built, capacity substitution can be sustainable if arrangements are affordable and can be maintained over the long-term.

Examples of Capacity Substitution:

- The use of banking services to make social welfare payments and payments to staff and vendors (Fiji)
- Audit firms carrying out financial audits of government ministries (RMI and FSM), and management of sovereign wealth funds (Kiribati)
- Roles of Auditor General and Accountant General being allocated on a long-term basis to expatriate advisors
- In the Cook Islands, the post of Financial Secretary was recently recruited internationally in order to attract a wider range of candidates for the role.

There are many examples internationally of contracted out PFM functions. Examples include procurement (Afghanistan, Southern Sudan), customs (Angola and Mozambique), tax collection (Sierra Leone), Treasury systems (Afghanistan), legislative drafting of budget laws and procurement laws (Afghanistan), and accounting and auditing (Southern Sudan). In Sierra Leone 'local technical assistants' have been used over the long-term to perform roles such as Deputy Accountant General and Director of Budget under donor-funded contracts. ODI has run the 'ODI Fellows' scheme for a many years, providing additional capacity in in-line positions, in the form of young economics graduates. Using a rolling cycle of younger staff beginning their career allows for relative cost efficiency compared to using more experienced professional consultants.

3.2. Deciding Between Options

Countries need to consider which approach, or combination of approaches, is most appropriate to address identified capacity needs. The best approach for any given function will depend heavily on country context, political willingness to consider alternative approaches, the availability of financial resources, and the capacity to manage contracted private-sector contractors. For example, an institution that is committed to reform of staff and systems but has some immediate critical capacity gaps may wish to combine a long-term 'traditional' capacity-building intervention alongside immediate capacity substitution through deploying long-term donor-funded staff on a rolling basis. Alternatively, where commitment to reform is weak and existing capacity is adequate for basic processes, a capacity-supplementation approach using regional bodies or regionally sourced senior advisers to 'inspire' reform towards the next step may be preferable. All approaches to accessing capacity rely on political support for that model, and this must be a primary consideration. The following table presents factors for considerations when deciding between different approaches.

Approach	Possible benefits	Necessary conditions
Capacity Building	• Local capacity is under the direct control of the government, which is important for some sovereign state functions • If local capacity can be sustainably developed, this often represents the lowest-cost option, avoiding travel costs and international fee rates associated with other alternatives.	• Absence of easily-acquired skills must represent the primary constraint to desired reforms, rather than low staff numbers or absence of highly-trained specialists • Capacity can only be built if there are adequate numbers of staff with a necessary base of knowledge and skills, and with sufficient time available for further training • Some certainty is required that staff involved in capacity development will not be rotated out of current roles or leave the public service upon completion of training.
Capacity Supplementation	• Enables quick deployment of specialised technical skills, which may not be available locally, to perform important tasks or support reform processes.	• Adequate resources are required, either from Government or donors, given that TA is often expensive • Arrangements need to ensure sustainability, either through certainty that required resources will be available for continued TA assistance, or by ensuring that there is adequate transfer of skills to allow local staff to continue the function once TA is complete • Necessary oversight and monitoring needs to be in place, through government or donors, to ensure that TA is providing appropriate advice and assistance.
Capacity Substitution	• Provides access to skills and expertise that would not otherwise be available • Ensures that skills can be accessed when necessary, while avoiding the potentially large costs of building these capacities internally • Can create opportunities for improved quality, through contracts that emphasize performance and results.	• Political support is an important pre-condition, as there may be concerns about loss of control or opportunities for patronage or rent seeking • Adequate resources to finance outsourcing, from Government or donors, need to be identified over the long-term to avoid disruptions in functions due to financing constraints • Sufficient local capacity is required to manage an outsourcing process, including procurement and contract management.

There are a number of practical issues that need to be considered when deciding on capacity options, as follows:

- **Specialised technical complexity of specific functions:** More demanding technical and specialised PFM skills are difficult to establish and costly (or difficult) to retain. Examples of such skills might include specialist accounting, fiscal policy, modelling, IT, and forecasting skills. In these instances it may be cheaper and less risky over time to use pooled regional resources or outsourced arrangements to establish formal contractual arrangements. In some cases, it may be appropriate to accept that this type of specialised capacity will be beyond the PFM reform capability in the short/medium term (i.e. that the good enough PFM function may need to work without some specific very specialised skill, (e.g. judges to hear tax appeals).

- **Efficient scale for providing specific functions:** A feature of the Pacific region is the prominence of many small island States that cannot take advantage of scale, but are still expected to provide certain PFM functions at an adequate quality. This comes at a high cost. It is in the interests of PICs to undertake some of these functions at an international scale to reduce this cost burden without compromising sovereignty or national interests. A regional approach is one way to reduce costs through the sharing of skilled resources or knowledge. Outsourcing can realise similar advantages, particularly if done in collaboration with other PICs.
- **Funding constraints and options:** The appropriateness of outsourcing will depend on affordability and the extent of available donor support. There are three common models of contracting out service delivery which could all be appropriate in particular circumstances:
    1. **Locally funded and managed:** The partner government executes the contract with funding from its budget.
    2. **Externally funded, locally managed:** The partner government executes the contract with funding from multilateral organisations, bilateral donors, foundations or other external funding sources.
    3. **Externally funded and managed:** External funding entities, such as donors, finance, execute, and manage the contract for services, in close collaboration with the end users and/or partner government.
- **Capacity for managing external providers:** Contracting out requires specific capacities, ranging from procurement, legal framework and contract management skills. Capacity for contracting needs to be addressed to avoid the risks associated with either: i) badly specified contracts or long delays in contracting; or ii) reluctance to pursue contracting options, even when this would represent the best solution, given shortages of capacity to manage the process. In countries with limited populations (i.e. limited pool of skilled human resources) it may be appropriate to establish long-term outsourced arrangements. Alternatively, in some circumstances it may be appropriate to separate provision of services from capacity building.

Decisions also need to be made regarding the appropriate duration for various approaches. Different models for accessing specific capacities can be used in different ways over time, with different approaches applied over the short and longer term. Externally-sourced capacity is often viewed as a short-term option, to be provided only until local capacity can be developed. But permanent external provision of certain functions has often proven cheaper, more sustainable, and less risky in some PICs, due to limited availability of specialized local staff to take on all required functions, even over an extended timeframe.

3.3. Lessons from International Experience

There is extensive international experience to learn from. Many reviews of capacity building projects have now been conducted globally and within the region. These reviews highlight that improving capacity is difficult and outcomes often fall short of objectives. Lessons from regional experience include:

- **Strong ownership and political leadership is required.** Capacity building efforts in PICs have often suffered from a lack of engagement and ownership. No approach to accessing additional capacity will succeed without the support of leaders and decision-makers. Ownership of capacity planning processes and broad agreement to the use of various approaches is vital. Sufficient time for discussion of capacity needs and means of fulfilling these needs must be allowed when planning PFM reforms.
- **Extensive planning and long timeframes are necessary**. Capacity building efforts in Pacific countries have often been fragmented, sporadic, and inadequately planned. Timeframes for capacity building have often been under-estimated and frequent changes in the involvement of donors, in the scope and coverage of capacity building projects, and in the advisors that are financed by such projects has led to duplication and gaps. A structured approach to capacity building should be based on a broader training needs assessment (this would generally include PFM as part of a broader needs assessment), with the government having a long-term vision of its capacity needs and commitment to specific areas and outputs from key donors. Based on experience in the Pacific, timescales of 10 years should be considered as a realistic period to build capacity with a view to a sustainable solution. Capacity assessment should consider what level of skills currently exist, broader and specific training needs, and mechanisms to address the needs over time. Where capacity levels are low or resources are constrained it is important to consider alternative approaches to capacity building, including capacity supplementation and capacity substitution. Involving agencies with responsibility for workforce planning and training, such as public service commissions, is important.
- **Role clarity and appropriate accountability arrangements are vital.** In PICs, capacity substitution is frequently used, but its use is sometimes not explicitly acknowledged. This is problematic, as capacity substitution goals are not reflected in project monitoring and evaluation arrangements, leading to a lack of accountability. Advisors contracted to build capacity but fulfilling in-line roles typically report to donor agencies rather than to Government, undermining ownership and management. Funding for such advisors is typically available only for a fixed period, generating risks for sustainability when in-line roles are being performed without an exit strategy. Greater willingness to explicitly employ capacity supplementation and capacity substitution approaches is needed combined with up-front clarity on reporting lines and accountabilities, and with direct accountability to government generally most appropriate for capacity substitution models.
- **Sustainability can be achieved in different ways in different contexts.** Claims that long-term capacity supplementation and capacity substitution are less sustainable need to be carefully tested. Capacity supplementation and capacity substitution can be delivered sustainably if costs are acknowledged and planned for. At the same time, experience in PICs shows that specialised technical skills may be costly to develop within countries and difficult to retain – regional or

outsourced approaches may sometimes be cheaper and more sustainable. Further, there is an opportunity cost in dedicating scarce skills in areas that are not critical (for example, resourcing administrative functions can divert capacity away from policy development, where local staff might be better utilized). It is important to recognise that advanced economies take advantage of outsourced service provision to enable civil servants to focus on core government roles and responsibilities.

3.4. Regional Approaches

Regional solutions present important opportunities for addressing capacity constraints to PFM reform. Existing regional approaches involved in addressing PFM capacity gaps include: i) shared training facilities and courses (the University of the South Pacific and the Pacific Islands Centre for Public Administration); ii) pools of skilled and specialist resources that can be shared across countries (PFTAC, Forum Fisheries Agency, the Secretariat of the Pacific Community); and iii) opportunities for networks of information sharing (Pacific Islands Financial Managers Association and Pacific Islands Tax Administrators Association). Potential benefits from regional solutions include:

- **Efficiency gains through economies of scale and specialization.** Regional approaches offer the opportunity to address challenges associated with small populations and small public services through pooling of resources and skills. It may not be possible or desirable to develop particular specialized skills within each country if those skills will be seldom used (a mining tax policy specialist, for example, will only be required when mining tax policies need to be developed or updated). Greater specialization becomes possible if skills can be applied across several countries. Regional approaches can achieve economies of scale, provide a higher level of services at less total cost, with fewer facilities, greater efficiency, and a higher degree of shared knowledge. A shared approach allows national governments to focus on national priorities rather than spending scarce resources on duplicating services.
- **Development of regional experience.** Regional approaches can also support the acquisition of relevant regional experience on behalf of PFM subject specialists, leading to higher quality advice and reducing the amount of investment required in familiarization.
- **Harmonized approaches.** Regional approaches can encourage the adoption of similar systems, standards and policies across countries, allowing further economies of scale and facilitating transfer of specific capacities and skills (for example use of common revenue and customs IT systems allows economies of scale in training).

Due to resourcing problems and political conflicts, regional approaches in the Pacific have not always been as successful as hoped. Collective action problems have undermined the sustainable financing of regional institutions. In some cases, PICs have been reluctant to access the services and advice provided by regional institutions due to real or perceived compromises of sovereignty. Before pursuing region approaches to addressing capacity gaps, the following conditions must be in place:

- **Certainty that regional institutions can reliably deliver solutions.** Political support and adequate, sustainable, resourcing is required for effective functioning of regional organizations and institutions. Regional organizations must operate effectively and sustainably if they are to be relied on to cover capacity gaps. Donors have a role to play in financing the development of regional capacity institutions in order to overcome inherent collective action problems associated with subscription-based models. Merit-based appointment of appropriate individuals to governing bodies, which include adequate representation from member countries, is important.

- **Political commitment to regional solutions.** Clear decisions need to be made regarding which functions it is appropriate to have fulfilled by regional agencies in a particular country context, taking account of political sensitivities regarding sovereignty and core state functions. While possible efficiencies from regional approaches can be identified in terms of whether costs can be reduced through delivery at an international scale, political considerations are likely to also be important. Regional solutions are unlikely to be sustainable or successful if they face strong political opposition.

Case Study: Regional Delivery of Services - Pacific Regional Audit Initiative

The Sub-regional Audit Support (SAS) programme is one of the programmes of the Pacific Regional Audit Initiative (PRAI), under the Pacific Plan. The Supreme Audit Institutions (SAIs) in Kiribati, Nauru, and Tuvalu are at differing development stages, but face similar challenges in the areas of human resource capacity and the efficacy of their audit methodologies and systems.

Common challenges include the small number of trained and qualified personnel, the disproportionate effects of staff turnover or absences, and difficulties in attracting and retaining staff. These issues mean that public accounts are often not audited to high standards in a timely manner. As a result, the SAS programme was introduced for Kiribati, Nauru, and Tuvalu in response to these concerns. The SAS approach requires four auditors from the three countries to work on a co-operative basis in the audit of government entities in the three countries. A mix of capacity supplementation and capacity building approach was used to help sustain efforts.

Some of benefits from the audits include:

- An increased understanding of the role of Supreme Audit Institutions within the audited entities, including a two-way understanding of information required for preparing financial statements and their subsequent audit; and
- Internal capacity development with each Supreme Audit Institution, including identification of champions for improved audit practice, improved understanding of audit issues, and improved documentation for supporting opinions and management recommendations.

3.5. Risks and Risk Mitigation

Implementation of a PFM roadmap and the development of capacity are vulnerable to both political and technical risks. Possible risks and appropriate mitigation measures are listed in the following table:

<table>
<tr><th></th><th>Risk</th><th>Mitigation</th></tr>
<tr><td rowspan="4">Political Risks</td><td>Lack of understanding and commitment to the PFM roadmap. Without a common understanding and commitment by Government (including Cabinet) and donors it will be difficult to mobilize necessary resources and sustain capacity building efforts.</td><td rowspan="4">Political risks arise when the incentives associated with different approaches to capacity development have not been adequately assessed and a decision is taken without sufficient support or understanding from key stakeholders. Government can reduce these risks through a range of actions:

• Information sharing on the benefits and perceived costs. This should include discussion of positive experiences and the benefits that have accrued in the region.
• Policy discussions on how best to make use of local capacity and how this can be supplemented with alternative approaches. This would include discussion on what functions should be supported by external resources and how this will impact on state sovereignty.
• Efforts to improve incentives and reduce resistance. This will likely include discussions with staff concerned about the reforms or new approaches to capacity.
• Pilot approaches to demonstrate the benefits, feasibility and expectations of what can be achieved.
• Appropriate design of contracts to ensure they deliver the services as intended by Government.</td></tr>
<tr><td>Lack of consensus on approaches to capacity building and maintaining state sovereignty. Political consensus is required to support shared regional approaches and capacity substitution. Common understanding is required of the impact of bringing in outside resources, risks, how risks are to be managed, and what functions should be considered as sovereign state functions that should not be contracted out (see Appendix 6: Core state functions).</td></tr>
<tr><td>Unrealistic expectations. Capacity building takes time. Realistic expectations are required regarding the likely pace and extent of change.</td></tr>
<tr><td>Bias towards established arrangements. Organizations are often resistant to change. But relying on past practices may not be ideal and may come at a significant cost.</td></tr>
</table>

	Risk	Mitigation
Technical Risks	**Inadequacies in the enabling environment:** Legal frameworks, policy, procedures, and accountability arrangements may be an impediment to capacity development plans. Weaknesses in these areas may mean that initial progress is heavily reliant on donor funded and contracted technical assistance.	Technical risks arise when capacity, information systems or processes are inadequate. This is a significant risk to effective outsourcing arrangements. Government can reduce these risks through a range of actions: • Build regional connections to understand what support/capacity sharing is available from the private sector or regional institutions. Develop understanding of local or regional suppliers who may be capable of delivering required services. • Select or develop technologies, systems and process that may be more suitable to the regional context. • Review and develop procurement systems and capacity to ensure there is the ability to manage outsourced arrangements. This could involve use of technical assistance.
	Information gaps: there may be inadequate information to choose between capacity building alternatives, such as service delivery costs, supplier alternatives and availability, knowledge of regional contacts.	

Attachment 1: Applying the Prioritization Framework

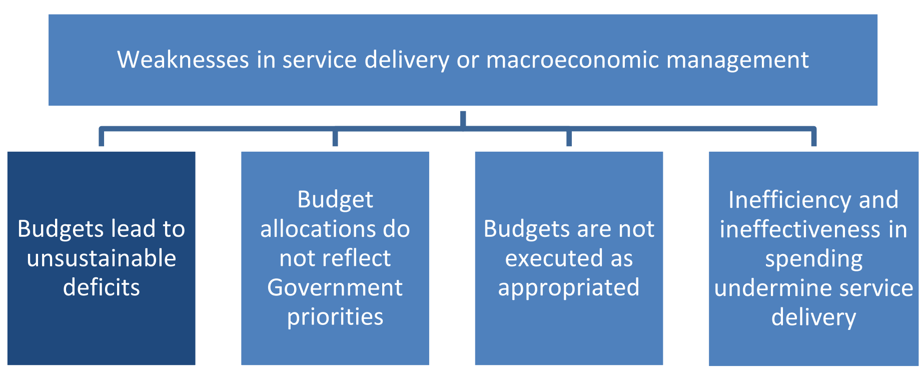
This attachment provides additional guidance regarding the application of the prioritization framework presented in Section 2. We apply the prioritization framework to a hypothetical small Pacific Island country to illustrate how it can be used to identify priority PFM Reforms.

The framework is intended to assist in identifying PFM reform priorities based on their linkages to broader development challenges. As discussed above, the prioritization framework outlines a non-prescriptive process approach to identifying relative priorities for PFM reform efforts in contexts where achieving across-the-board improvements is unlikely to be possible because of resource and capacity constraints. As noted in Section 2, factors that may influence PFM reform priorities include political imperatives, the capacities of available staff, development partner requirements for budget support or project assistance, and windows of opportunity arising from particular pressures or needs. This framework is focused on identifying those reforms that will have the greatest impact in addressing particular development challenges that may be facing a country.

A. Initial Problem Identification

The figure below shows four common PFM challenges that often undermine macroeconomic management and service delivery in PICs. This typology of problems can be used to make an initial high-level decision regarding the most significant PFM-related challenges facing a country. A decision at this level will identify the ***outcome-level problem*** to be addressed through resolving PFM weaknesses diagnosed during subsequent steps.

Figure A1: Initial Problems



Several different approaches could be taken when deciding which of these problems is the most important. Input to this decision is likely to include:

- **Consultation with Ministers and officials.** PFM reform is a Government responsibility and needs to reflect Government priorities. The views of Ministers and officials will be relevant for identifying the most substantial problems to be addressed through PFM reforms.

- **Review of existing data and analysis.** Relevant budget and macroeconomic data (such as the IMF Article IV report), and sector or whole-of-government Public Expenditure Reviews can shed light on the constraints to development progress that could be addressed through a better PFM system.

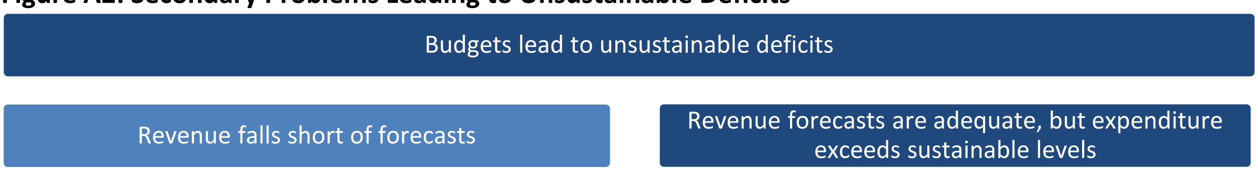
Many countries will be experiencing more than one of the problems identified. At this stage, the objective is to identify relative priorities between various problems. Prioritization is not possible if all problems are identified as equally urgent. It will generally be appropriate to identify one or two problems that are the greatest priority for initial attention.

In our example case, the Government is most concerned about budgets leading to unsustainable fiscal deficits. A common concern identified in both recent analytical work and consultations with Ministers is the recent growth of the fiscal deficit. This growth is seen to be threatening future development prospects, with management of the deficit viewed as a key priority for any PFM reform work.

B. Secondary Problem Identification

The figure below shows the secondary problems associated with the initial outcome-level problem identified above ("Budgets lead to unsustainable deficits"). Following the identification of an outcome-level problem, PFM reform teams can identify the ***secondary problems*** causing the outcome-level problem identified above. The subsections of Section 2 list the ***secondary problems*** leading to each of the initial problems listed in Figure A1.

Figure A2: Secondary Problems Leading to Unsustainable Deficits



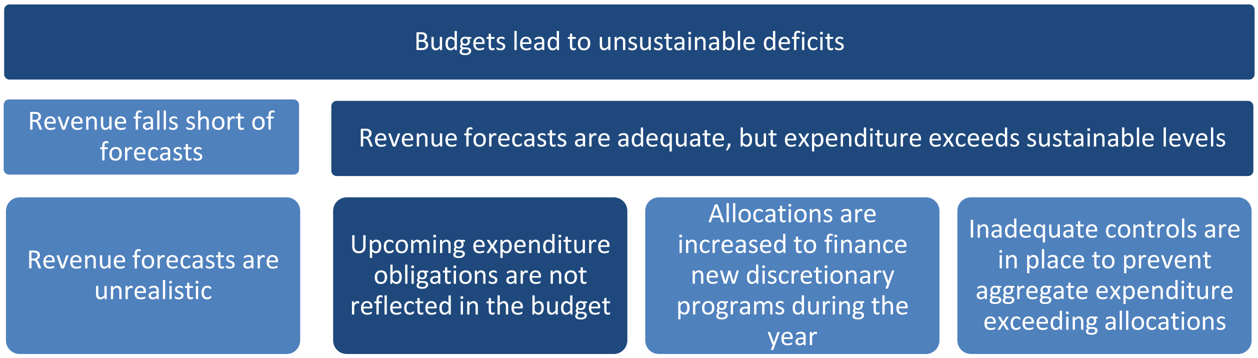
In our example, the Government is concerned about unsustainable deficits. Assuming that a country begins the year with a balanced budget, deficits must be driven either by revenue falling short of budgeted levels or expenditure exceeding limits set in initial budgets. Based on a review of fiscal data and discussions with officials, it should be possible to verify whether deficits have been driven by revenue shortfalls, excess expenditure, or a combination of both.

In our example case, the PFM reform team concludes that revenue forecasts are generally accurate, and problems have arisen on the expenditure side. This conclusion is reached through a review of budget documentation, which illustrates the impact of supplementary budgets in driving additional in-year expenditure beyond budgeted levels. This pattern is also noted by the IMF in their recent Article IV report.

C. Identification of PFM Weaknesses

Figure A3, below (an expanded version of Figure A2), links *secondary problems* to relevant *PFM weaknesses*. Following identification of the secondary problem that is driving the outcome-level problem through the process above, it is necessary to identify the ***PFM weaknesses*** that are causing these problems. Subsections of Section 2 provide a disaggregation of the various PFM weaknesses that could be leading to the observed secondary problems.

Figure A3: Links between problems and PFM weaknesses



In our example case, the PFM reform team can use this framework to consider the PFM weaknesses that might be leading to expenditure exceeding sustainable levels. Different causes of increased in-year expenditure will have different implications for PFM reform priorities. Problems could include the need to increase expenditure to deal with unbudgeted, non-discretionary pressures. Alternatively, expenditure could exceed established limits because additional discretionary expenditure is approved without identifying funding sources. Finally, expenditure could exceed established limits simply because of inadequate controls in procurement and payroll. Of course, it is also possible that more than one of these weaknesses contribute to expenditure exceeding established limits or that a completely different set of weaknesses are causing the problem.

In our example case, the PFM reform team concludes that the increases in expenditure during the year are driven by the emergence of non-discretionary pressures. During consultations, the team finds that inadequate budgeting for debt repayment obligations and unforeseen SOE subsidy requirements have been a primary driver of recent expenditure beyond budgeted limits. The need to meet these obligations, for which allowances have not been made in the budget, is considered an important problem, given that ministers and officials are aware of the negative implications of in-year expenditure increases for the overall fiscal position.

D. Identification of Priority PFM Reforms

At this point, it is possible to move from analysis of PFM weaknesses to *potential reform solutions*. Reform solutions for the full range of PFM weaknesses are discussed in Section 2. Linkages between these reform solutions and relevant PEFA dimensions are shown in accompanying tables. Table A1, below, shows the full range of PEFA dimensions that could be relevant when fiscal sustainability is undermined by increases in non-discretionary expenditure to meet unexpected pressures.

Table A1: Relevant PEFA dimensions when expenditure obligations are not reflected in budgets

➢ **PI-1: Aggregate expenditure outturn compared to original approved budget** ➢ **PI-4: management of arrears** ➢ **PI-9: oversight of fiscal risks of public entities, including state owned banks and enterprises** ➢ **PI-12(ii): scope and frequency of Debt Sustainability Analysis.** ➢ **PI-17: processes for approving, recording and reporting on loans and guarantees.** ➢ **PI-2(ii): Actual expenditure charged to contingency vote** ➢ PI-12(i): existence of multi-year fiscal forecasts ➢ PI-8: transparency of fiscal relations with sub-national government	**Priorities:** • Priority reforms will depend on whether expenditure pressures are being driven by limited understanding of debt dynamics and debt servicing costs (PI-12ii and PI-17); insufficient knowledge of fiscal risks from SOEs (PI-9); the build-up of arrears (PI-4); or genuinely unforeseeable shocks. • Countries with stable debt dynamics may be less concerned about frequency of debt sustainability analysis, which is emphasized in the PEFA framework. • While detailed multi-year fiscal forecasts may not be necessary (PI-12i), some mechanism for capturing significant future fiscal implications of major policy decisions is likely to be needed – this could include a basic system for recording upcoming fiscal risks and a register of high-value assets. • PI-8 is unlikely to be important for most PICs, given limited fiscal decentralization. **Gaps:** PEFA measures check the existence of systems and processes for recording future obligations, but do not assess the quality of analysis, which can be equally important.

In our example case, increased expenditure is driven by inadequate allocations for debt repayments and inaccurate forecasting of SOE subsidies. Through the prioritization steps taken so far, a clear link can be established between unsustainable deficits and better forecasting and budgeting of debt repayments and SOE subsidy payments. ***If the Government's priority is to address unsustainable fiscal deficits, it makes sense for scarce PFM reform capacity and resources to be focussed on the PFM functions that might address this problem.***

Links with the PEFA framework need to be carefully considered. Several PEFA dimensions are directly relevant to the forecasting and budgeting of debt servicing obligations and SOE subsidies. But it is not immediately clear that higher scores against each of these dimensions is an appropriate goal for the PFM reform process. Instead, the team may wish to specify the steps that need to be taken to address the problems that are being faced. For example, the following PEFA dimensions might provide important information regarding current performance and extent of progress, but achieving high scores may not be an appropriate goal:

- **PI-9 (oversight of fiscal risks of public entities, including state owned banks and enterprises).** The PEFA measure assesses the submission of fiscal reports from Public Enterprises to Government, and Government production of a summary fiscal report. But it may be possible to work with SOEs to achieve improved forecasting of subsidy needs without submission of a formal fiscal report. Conversely, even if fiscal reports are submitted, this will not improve the outcome unless these reports are integrated into budget planning (which is not measured by this PEFA dimension).

- **PI-12(ii) (scope and frequency of debt sustainability analysis).** Information from a DSA might assist in planning for repayments and understanding debt dynamics. But the PEFA dimension measures only the frequency of DSAs. Even a very-recent debt sustainability analysis will not help if this analysis is not reflected in the budget. Similarly, adequate information may exist from an older DSA or from other information sources to improve planning of debt repayments.
- **PI-17(i) (quality of debt data recording and reporting).** This indicator measures the completeness of debt records, the frequency with which they are updated, and the comprehensiveness of accompanying management reports, including coverage of debt servicing. But this measure does not assess the extent to which debt service obligations are reflected in the budget. Further, the indicator emphasises frequency of reports and Government compilation of comprehensive overview reports – neither of which might be a priority to achieve the simple objective of reflecting debt repayment obligations in the budget.
- **PI-12(i) (multi-year fiscal forecasts and functional allocations).** This dimension assesses the existence of a multi-year fiscal framework (with different scores for different levels of detail) and linkages with the annual budget. While a multi-year framework could help in ensuring adequate allowance for debt repayment obligations and SOE subsidies in the budget, the detailed information on functional allocations associated with a high score may not be considered necessary or a good use of scarce resources.

Overall, while PEFA scores can provide useful guideposts and monitoring information for PFM reform plans, higher scores against individual PEFA dimensions may be neither necessary of sufficient to assess progress towards addressing identified PFM weaknesses.

In our example case, the team identifies PFM reform actions to address inadequate forecasting of and budgeting for debt repayments and SOE subsidies. These reform actions are not intended to improve PEFA scores, but to address the identified weakness. Examples of some of the actions that could be taken and their links to the PEFA framework are shown in the following table.

Action	PEFA Linkage
MoF to work with SOEs to ensure provision of fiscal report to the budget team, including forecast Public Service Obligation subsidy requirements, on an annual basis and in time for the budget process.	Increase score against PI-9(i) from D to C with annual fiscal reporting from major PEs. Submission of audited accounts required for a 'B' score, but considered unlikely to be achievable at this time. Government production of consolidated report required for a 'B' score but not seen as a priority, as long as the subsidy requirements are reflected in the budget.
Debt repayment obligations to be calculated on a quarterly basis by MoF, with most recent records used to inform annual budget allocations.	Increased score against PI(ii) from D to C. Improved records of debt stocks are a priority and would lead to a 'C' score. Quarterly reconciliation considered adequate, rather than more-frequent reconciliation required for a higher score. Comprehensive management reports not considered necessary at this stage, which are necessary for a higher score.
Budget estimates and associated documentation revised to include specific and adequate allocations for debt repayment and SOE subsidies.	Not specifically measured in PEFA framework.

Attachment 2: Good Practice in Pacific PFM Roadmaps

PFTAC and the Pacific Islands Forum Secretariat have previously provided guidance on good practice in planning PFM reforms. Recommendations in this guidance note are consistent with these messages, which include:

It is important for countries to take ownership of the PEFA assessment and PFM Roadmap. This will ensure that the assessments contribute to the reform process. This requires engagement from senior and middle level staff in their preparation – not just as information providers, but as partners in the preparation of PEFAs and Roadmaps. This not only creates ownership, but also provides an educational opportunity, developing country staff so that over time they will be able to take more responsibility for driving PFM reform. It also institutionalizes the practice of regular self-assessment and self-improvement as part of the cultures of PIC ministries of finance.

This requires time and careful planning. PEFAs and Roadmaps should only be started at a time of the year when key staff will be least distracted by other matters. A PEFA will require at least 4-5 weeks (2 weeks for a self-assessment and 2-3 weeks for a formal assessment) of fairly intense staff involvement.

Formal assessment teams should be appropriately staffed. Teams should be composed of around 3-4 people, with at least one member from the Government and one from a regional agency or peer country. Two experts will also normally be required (one of whom will probably have facilitated the self-assessment exercise). Additional expertise may also be required for additional assessments in areas such as procurement.

Consultation with donors is also important. It should come both beforehand, through review of the terms of reference and team briefing, and also at the end of the process. The government should be in the lead in the consultation process

A "low" PEFA score does not necessarily require action. PEFAs only tell a government how they are performing relative to what is generally considered best practice. Countries may not consider it appropriate to move to better practice across the whole range of PEFA scores. This may be because of constrained resources/capacity or because a country does not consider a higher PEFA rating to be desirable. Desiring a higher rating signals that a country wants to improve operations in a specific area, but there can be many routes to that condition.

Roadmaps should be about much more than just raising PEFA scores or meeting a donor requirement. They should not become just another plan-- created, published, and delivered to fulfill a donor requirement. Roadmaps should only be prepared if Government believes that improved PFM is important to improved delivery of public services; and they are committed to implementation. A properly prepared Roadmap will clearly indicate the actions that can and will be taken to arrive at the desired state and the timing of those actions. It should also identify the type of development partner support that will be required to achieve sustainable improvements—engaging key partners during drafting is therefore critical.

Sound and disciplined PFM is not just a technical matter. Many of its most significant aspects hinge on how Cabinets and Legislatures deliberate on fiscal and policy issues, and in particular on how they integrate thinking about public service policies, budgets, and revenue constraints in arriving at decisions. PFM Reform Roadmaps should address these issues and should be formally approved by Cabinets.

Source: *Update on Public Financial Management Reform Roadmap, Forum Secretariat and PFTAC, July 2012*

Attachment 3: Appendices

Appendix 1: The PEFA framework and the Strengthened Approach

The Public Expenditure and Financial Accountability (PEFA) framework is a management tool to assess the strengths and weaknesses of a country's PFM systems. It is based on a global, standard set of high-level indicators, which is applicable to all countries, from OECD countries to post-conflict states, regardless of population, income level, or form of government.

The assessment examines:

- Credibility of the budget: **is the budget realistic and implemented as intended?**
- Comprehensiveness and transparency: **are the budget and the fiscal risk oversight comprehensive, and is fiscal and budget information accessible to the public?**
- Policy-based budgeting: **is the budget prepared with due regard to government policy?**
- Predictability and control in budget execution**: is the budget implemented in an orderly and predictable manner and are arrangements in place to exercise control and stewardship in the use of public funds?**
- Accounting, recording and reporting**: are adequate records and information produced, maintained and disseminated to meet decision-making control, management and reporting purposes?**
- External scrutiny and audit**: are the arrangements for scrutiny of public finances and follow up by the executive operating effectively?**
- Development partner practices**: which elements of these practices have an impact on the performance of country systems?**

Accompanying the launch of the PEFA framework in 2005 was a set of principles to guide the development of jointly-supported PFM reform programs, to which both governments and donors could commit. This was called the Strengthened Approach (SA). The SA was motivated by recognition of common shortcomings in traditional PFM-strengthening approaches. These included*:*

- Information required by donors implied duplication and a heavy burden on partner governments
- Traditional development partner interests in PFM tended to: (i) discourage government to take the lead in defining its reform priorities; and (ii) lead to over-ambitious and fragmented agenda
- A lack of evidence-based information on progress made in PFM performance prevented focus on results and dissemination of good practices.

The SA was intended to support coordinated effort to address these shortcomings through:

- A country-led agenda – a country-led PFM reform strategy and action plan
- A coordinated program of support – coordinated, multi-year program of PFM work that supports and is aligned with the government's PFM strategy
- Focus on results – a common framework and information pool for assessing and measuring results over time.

Appendix 2: Background to PFM Roadmaps in Pacific region

PEFA assessments have been carried out in the Pacific region since 2005. To date, thirteen governments in the region have completed such assessments and seven have carried out repeat analyses. On the basis of these assessments, a number of governments in the region have prepared PFM roadmaps to address the challenges highlighted in the PEFA reports.

The initiative to develop PFM roadmaps based on PEFA assessments emerged from the 40th Forum Leaders Meeting (Cairns, 2009) and was intended to facilitate improved economic and development performance in the region. Thereafter, the 2009 Forum Economic Ministers' Meeting (FEMM) endorsed development of a regional Roadmap to strengthen Forum Island Countries' PFM, which was completed and endorsed in 2010. PIC's regional PFM Roadmap was based on the FEMM Forum Accountability Principles (2007). PFTAC would provide co-ordination and quality control, as well as technical support, for PEFA assessments and the development of roadmaps.

It was agreed that the roadmaps were to cover expenditure management, revenue, and procurement to raise the effectiveness of mechanisms to enhance delivery of development resources. Emphasis was on improving service delivery/development outcomes. This led to the preparation by the Pacific Financial Technical Assistance Center of a PFM Workbook to provide hands-on guidance to PIC governments in developing their own roadmap.

To date, eight PICs have PEFA-based PFM roadmaps in place.

Appendix 3: PFM Roadmap Communication Strategy

Purpose of communication strategy:

- To ensure that all key stakeholders are aware and informed of the progress and actions being implemented under the plan

Elements of communication strategy:

- Clear management and accountability structure established for oversight and management of Roadmap implementation;
- Official distribution of PEFA assessment and PFM Roadmap to stakeholders and to the public;
- High-level presentation to ministry heads and finance managers;
- Integration of measures in Roadmap into annual budget process by both MoF and line agencies (e.g. through budget circulars and line agencies' budget plans);
- Regular in-year reviews and reporting of progress by MoF and line agencies;
- Annual progress meetings with key stakeholders, including high-level political and technical participants.

Appendix 4: Diamond Good Practice Note on Designing a PFM Reform Program

A recent Good Practice Note from the PEFA Secretariat presents a complementary framework for developing PFM reform plans, based on a decision-tree approach. This approach is summarized here:

Phase	Activity	Output
1. **What needs to be done:** Analyze and diagnose PFM needs, including non-technical (political economy and other risk) factors	Analyse PEFA scores. Supplement analysis with other PFM information. Identify non-technical factors. Identify relevant risks.	List of what needs to be done
2. **What is possible:** Balance what needs to be done (technical factors), with what can be done (given external constraints) and what is locally-demanded (based on political economy factors)	Identify the reform actions. For each reform action, identify the conditioning (climate for reform), institutional (how well PFM system can cope with reform) and organizational (absorptive capacity) factors. Analyze the risks of each reform action.	Possible reform agenda
3. **Consult to decide what is wanted.**	For what needs to be done and what is possible, consider the relative priorities. For what is wanted, consider the government's strategy.	Reform actions
4. **Design the reforms**	Consider sequencing issues: the order in which reform actions are to be taken and the timing of these actions	Agreed and sequenced reform program
5. **Construct an effective delivery mechanism**	Ensure adequate resources. Include measures to enlist local pressure for reform. Invest heavily in change management (political sponsors who demand/support change and senior civil service management) to lead implementation.	Action Plan

Source: Diamond, J. (2013), Good Practice Note on Sequencing Public Financial Management (PFM) Reforms, PEFA Secretariat.

Appendix 5: Core requirements for sustainable capacity

Sequencing: Sequencing is essential to effective and sustainable capacity development. Capacity cannot be developed simultaneously in all areas, particularly in countries with small populations. Overcoming capacity gaps in certain areas is often a prerequisite to commencing successful capacity development in others.

Coherence: Capacity development initiatives need to recognize the links within and between functions, rather than a fragmented or ad hoc approach. For example, installation of a financial management system will not increase government capacity for financial management if government lacks trained staff to run the system.

Commitment: Capacity development takes time and long-term commitment.

Appendix 6: Core state functions

Some functions are considered integral to state sovereignty and cannot therefore be performed by a non-state entity. These include providing security and safety within the state's borders, managing international relations, engaging in diplomacy, gathering intelligence, and defending the nation. These functions are highly political and not suitable for contracting out.

While policy analysis and advice can contracted out, policy-making is best carried out by the state. This includes setting the policy framework, and making decisions about functions or services. For example, while the state may contract out some aspects of budget design, it should not contract out decisions about budgetary allocations or priority setting. These are decisions that should be made by elected officials, accountable to the public.