Linking PFM dimensions to development priorities

Bryn Welham, Philipp Krause and Edward Hedger

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Acronyms

FMIS	Financial Management Information System
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
HIPC	Heavily Indebted Poor Countries
LIC	Low-income Country
MTEF	Medium-term Expenditure Framework
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
SWAp	Sector-wide Approach

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Executive summary

In some approaches to discussion and practice of Public Financial Management (PFM) reform in developing countries, reforms are inspired by a comparison of current systems, as compared to an ideal state, often only found in wealthy countries. Reform programmes are therefore guided by an assessment of the gap between best practice and actual behaviour. However, for governments facing severe and prolonged capacity constraints, it may be unrealistic to expect achievement of 'best practice' – or anything close to it – in the foreseeable future.

An alternative approach would therefore be to focus on the specific development objectives governments are trying to achieve and their relationship to PFM reform. The findings of this analysis can then be used to prioritise certain PFM functions above others, and use this prioritisation to inform the design of a reform programme in a capacity-constrained environment. Four commonly desired development objectives that are often thought to be supported to some degree by certain PFM functions are: *macroeconomic stability; efficient resource allocation; service delivery;* and *state-building*.

The relationships between PFM functions and key development objectives

A review of theoretical and empirical evidence shows different relationships between the development objectives set out and PFM functions. On the question of macroeconomic stability, the ability of PFM systems to provide relevant information on status of, and risk to, debt and deficits is its most significant contribution. For efficient allocation of resources, PFM systems which focus on providing relevant information on available resources, and a timely budget preparation process that involves all stakeholders, can contribute to the right allocation. However, 'efficient' allocation can only be done in light of a pre-existing, politically determined expenditure strategy that chooses between various public spending priorities. In both cases, while PFM functions can support decision-makers with the correct financial information and efficient process management systems, they cannot ensure that appropriate decisions are actually made, or that they are then adhered to. Political incentives in the wider country context will be crucial in this regard, and PFM systems cannot directly affect these issues.

The link between PFM functions and service delivery is less clear. Regular payment of staff salaries is likely to be important to all public service delivery, but beyond this the relevant prioritisation of PFM functions to contribute to service delivery will depend on the nature of the sector being considered. The relationship between PFM functions and state-building is particularly complex, given that each of the three other development objectives are themselves theorised to contribute, to a greater or lesser extent, to an effective state. A focus on building PFM functions that can support a basic budget and regular payment of staff salaries as a stabilising and confidence-building measure, provide long-term information on revenue generation to help finance the state, and perhaps promote a social contract in the long-term, could provide the starting point for a reform programme.

Overall, the priority PFM functions identified as contributing to the specified development objectives are summarised as follows:

PFM functions and development objectives

Development objective	**Priority PFM functions identified as contributing to development objective**
Macroeconomic stability	• Timely and reliable fiscal and financial information • A basic understanding the overall debt position of the government • An awareness of key risks to the fiscal position of the government
Efficient allocation of	• Timely and reliable fiscal and financial information • A well-structured budget preparation process

resources	
Service delivery	• Regular payments of salaries and wages to staff engaged in delivering basic services • Beyond salaries, the PFM functions to be prioritised will depend on the nature of the priority public service sectors chosen
State-building	• Basic budgeting in the sense of expenditure control and execution ability • Regular and timely payment of public-sector salaries • Understanding of the current structure of the revenue base and options for expansion in the future

Overall, the tentative list above represents a prioritisation of a basic credible annual budget and the major risks to it; basic awareness of debt and cash-flow dynamics; and a focus on managing the public sector payroll. This set of tentative reform priorities would likely suggest a series of reforms that the ministry of finance is well placed to lead. In some fragile states, it has been noted that most progress in PFM reform has been made on functions that are controlled by the ministry of finance directly.

In practical terms, these recommended PFM functions are heavily interlinked and reforms could not be approached in isolation. In addition, these conclusions sketch out the 'breadth' of key functions that could be considered part of a PFM reform programme, but they do not provide detail on the correct 'depth' of reform. In all cases, a thorough analysis of local context and constraints will be necessary to design a reform programme that accurately matches the level of ambition to available capacity.

Delivering reforms in capacity-constrained environments

In capacity-constrained environments, reforms can either be rigorously prioritised to match capacity, or capacity can be increased in order to allow more to be achieved. While the above has considered the prioritisation of PFM reforms as one approach, this can be complemented by options for improving capacity in order to better match ambition to resources. A desire for capacity enhancement can come from within government, perhaps motivated by the prospect of additional donor funds, or from external actors.

Definitions of capacity enhancement are numerous and often imprecise. 'Capacity building', 'capacity supplementation' and 'capacity substitution' are not always clearly defined in different literature. A working taxonomy of capacity enhancement activities around three approaches of capacity building, capacity supplementation and capacity substitution are identified. Capacity building represents a 'traditional' approach of training and coaching permanent staff to improve their permanent ability to undertake certain tasks. Capacity supplementation is interpreted as being a set of interventions designed to fill advisory roles – not line positions – typically using personnel from outside the civil service. Capacity substitution is taken to mean the use of external staff filling line positions – not advisory roles – alongside regular staff, with no explicit objective of skills transfer. In practice, the distinctions between these categories may not be clear or absolute.

Some reviews of capacity development interventions by major institutions find a mixed record of impact, and there are many examples of a move away from 'traditional' capacity-building approaches to other substitution and/or supplementation modalities in some fragile and low-income environments. The literature appears to agree on the main features of successful capacity enhancement; notably a commitment from the partner agency to achieving change, and a package of interventions designed and owned by the partner institution itself. The literature suggests that capacity building in the Pacific and elsewhere is generally more successful where: long-term time horizon and substantial pre-design work is undertaken; peer institutions invest in long-term co-located support; there is clarity of expectation on both sides as to what kind of support is being delivered; and there are clear benchmarks for partner agency performance, coupled with flexibility on the specifics of the outcomes to be delivered.

The ‘right’ capacity enhancement intervention could involve a mix of different approaches depending on context. In terms of capacity substitution, there are examples of interventions that have used computerisation to substitute for low capacity, outsource entire discrete functions of PFM to external providers, and/or develop long-term (perhaps semi-permanent) placement schemes for a rolling supply of external staff to carry out basic PFM functions. Capacity supplementation approaches would include: formal institutional twinning arrangements with regional leaders; salary top-ups for key staff; use of international advisers from neighbouring countries to fill key posts; graduate internship schemes; confidential advice funded at arms-length by donors; use of regional and global professional bodies to support specific PFM functions; and/or use of existing donor processes to substitute for government processes.

1 Introduction

The relationship between PFM and key development objectives, how these might (or should) affect plans for PFM reform in Pacific Island countries, and experiences with different forms of capacity building are three complex and closely interlinked topics. This paper aims to provide a summary discussion of the key issues relating to each topic, and to link them together in the context of PFM reform in highly capacity-constrained countries, with some suggestions of areas for further exploration. Reforms are not free – they come at a cost in terms of attention, resources and political consequences. Potential reformers know this and will not pursue reforms entirely without reason.

Too often PFM reforms seem to be inspired by an assessment of the current system, as compared to an ideal state to be found in wealthy countries without significant capacity constraints. The resulting reform plan then takes as its basis the areas where the status quo falls short of the ideal state, without any deeper connection to priorities or sense of the problems that strengthened components of PFM are trying to address (Andrews, 2008). Assuming that political and bureaucratic elites are rational actors, such behaviour is confusing as it often does not lead to actual improved performance. In the literature, one explanation put forward is institutional isomorphism. Be it due to the professional aspirations of budget officials or pressure from donor agencies, or because there is uncertainty over how to proceed, reform templates mimic international best practice (DiMaggio and Powell, 1983). This isomorphism need not be a bad thing, but it often is (Krause, 2013b). It has been associated with limited reform success and is one of the reasons why fragile states are trapped in situations of low capability (Andrews, 2009; Pritchett, Woolcock et al., 2010).

Another ambiguous factor shaping PFM reforms is the role of donor support in aid-dependent countries. Donors place a strong emphasis on the probity of recipient countries' financial management in the context of providing aid via budget support (Knack and Eubank, 2009). For governments, aid via country systems is preferable to other aid modalities, given the lower transaction costs and greater fungibility of resources (Manuel, McKechnie et al., 2012). As a consequence, recipient governments have an incentive to pursue donor-sponsored PFM reforms if they are required as part of larger budget-support operations. However, reform pursued mainly in order to satisfy external funding requirements is one of the strongest sources of isomorphic pressure and not necessarily suitable for domestic priorities. Aid-recipient countries differ enormously in their institutional capabilities, political and bureaucratic arrangements and much else. It would be impossible to define a degree of PFM functionality independent of context that would objectively satisfy fiduciary risk concerns, and we will not attempt to do so here.

An alternative approach would be to focus on the specific development objectives governments are trying to pursue and their relationship to PFM reform. Given that public finances are deeply embedded in any modern state's bureaucratic and political institutions, these objectives may well differ. So far, governments do not have much guidance available that could help them frame a discussion about PFM elements as a suitable means to achieving a particular development objective. In this paper, we are aiming to take a first step in that direction. This line of thinking has much in common with a problem-driven approach to institutional reform (Andrews, Pritchett et al., 2012; Andrews, 2013). It assumes that governments can identify an actual problem they are trying to address via reform, and structure their measures accordingly.

Such a perspective will be particularly relevant for governments facing severe capacity constraints. The limits to institutional reform by best practice adoption are most severe where states lack the ability to autonomously adapt institutional solutions to their own context and match the scale of reform ambition to the resources available. An inability to do so becomes a grave problem where capacity is severely limited. For the purpose of contemporary reformers, it will not matter very much whether some of these constraints are effectively permanent (as in many small island states) or potentially subject to change (as in many post-conflict and fragile states).

The paper will discuss the relationship between PFM reform and four commonly desired development objectives: state-building; macroeconomic stability; efficient resource allocation; and service delivery in the context of constrained capacity. The discussion will review the theoretical links between these four development objectives and PFM functions and reforms, and then go on to review recent available empirical evidence in relation to the proposed theoretical links. Following this, the paper will use this analysis to identify those key PFM functions that relate most directly to the achievement of the development objective. The identification of relevant PFM functions as a result of the analysis will take place in the context of capacity-constrained environments, meaning that the identified functions will be stringently prioritised in order to match assumed low capacity. The PFM functions identified through this analysis could inspire a reform plan that aims to maximise the contribution of PFM to the achievement of these development objectives. It is by no means intended as a blueprint, but rather a guide to structure debate on which PFM dimensions to prioritise in pursuit of certain aims.

Apart from prioritising PFM reforms to better match existing capacity, tackling capacity constraints directly is an important concern for many governments. Governments are likely to seek more capacity in order to satisfy more ambitious reform plans. The paper will complement the discussion of priorities for PFM reforms with an analysis for capacity enhancement options. It will review some of the reasons why additional capacity is usually considered appropriate for developing better PFM systems in such contexts, and will suggest a list of capacity supplementation and substitution options that could be considered further.

2 The outcomes of public financial management

State-building, macroeconomic stability and service delivery are outside the immediate domain of PFM reform. That is, effective PFM systems will support the delivery of these objectives but improved PFM systems will not immediately result in an improvement in these areas. Other non-PFM related factors also affect these domains, and will be explored in the relevant sections. Efficient allocation of resources can be considered a more *direct* impact that PFM reforms will aim to substantively improve.

The concept of state-building itself can be seen as a result of the other three PFM-related development objectives listed above. The literature would suggest that the ability to raise revenue, operate some form of expenditure-disbursement system, deliver economic development and deliver some basic services are hallmarks of the existence of a state (OECD, 2011). Seen from the perspective of state-building, efficient allocation of a budget, macroeconomic stability and service delivery are direct contributors towards statehood. In practice, it could be that aiming for 'state-building-related' PFM reform will in fact mean aiming to work towards the other three development objectives, as they will directly contribute to the state-building objective.

Each section will review the literature discussing links between PFM reform and the specified development objective, and propose a prioritised list of PFM functions that would contribute to achievement of the four objectives. This list of functions might then form the basis of a PFM reform plan. Importantly however, the paper cannot address the details, depth or sophistication of any reform plan inspired by this analysis. That will depend heavily on the local context, not least the appetite and capability of the government for a change programme, the starting point represented by current systems, and the available resources to invest in reform. Reform programmes inspired by the suggested PFM functions may lead to very different reform programmes in different environments.

2.1 Links between PFM and achievement of macroeconomic stability

It is uncontroversial to state that government economic, fiscal and financial activity has a major effect on the macroeconomic situation of a country. The negative macroeconomic effects of government budgetary and economic behaviour are summarised in a paper by Fischer and Easterly (1990). They conclude that 'printing money excessively shows up as inflation, excessive use of foreign reserves leads to crises in the balance of payments, high foreign borrowing leads to a debt crisis, and too much domestic borrowing leads to high real interest rates and crowding out of private investment'. The same factors, notably deficit sustainability considered in terms of the debt-to-GDP ratio, are picked up by Pradhan (1996) in his framework for evaluating public expenditure. He notes the implications for government fiscal management.

A major link between PFM functions and government impact on the macro economy is control of fiscal deficits and overall debt management. PFM systems that support effective fiscal management and a debt strategy aimed at sustainability can contribute to an improved macroeconomic situation by avoiding unsustainable deficits.

At the empirical level, there are few studies on real-world PFM improvement demonstrably driving improvements in macroeconomic stability in developing countries. Reviewing synthesis and summary literature on the impact of PFM reforms, primarily in Africa, the most significant conclusion seems to be that there is some association between countries experiencing PFM improvement and strong economic growth (de Renzio, 2009; Andrews, 2010). However, the direction of causality is unclear and it is not straightforward that PFM improvement is in fact a driver of economic growth.

Case studies of PFM reform in fragile states show a common focus on, and most improvement in, restoring the related objective of aggregate budget discipline. That is often achieved by ensuring central control of treasury functions. Given the link between fiscal sustainability and macroeconomic stability, this would suggest that PFM reforms in fragile states can have a positive impact on macroeconomic stability by improving budget execution and overall control of deficits and debt.

As with other areas of PFM reform and achievement of development objectives, political incentives and other non-PFM-related factors are also important in delivering macroeconomic stability. The overall willingness of the political elite to control aggregate spending in the face of pressures for additional expenditures will be crucial in determining whether overall fiscal discipline is retained. The political power of the finance minister and the ministry of finance to act as guardians of the public finances will be a key determinant of whether macroeconomic stability can be retained.

The importance of a strong central budget authority is well established in the literature on OECD and middle-income countries (von Hagen, 1992; Alesina, Hausmann et al., 1999; von Hagen, 2004; Hallerberg, Strauch et al., 2009). The literature indicates that factors such as competitive elections and ideologically coherent governments, and other political factors, are causally related to strong finance ministries. Unfortunately, these findings rely on formal institutions and laws being more-or-less reliable proxies for actual behaviour. There is not much research into how well these findings travel to developing countries. That said, the PFM functions identified here can help inform decisions made within this political dynamic, but cannot substitute for the right political incentives to maintain budget discipline, avoid unsustainable deficits and therefore risk macroeconomic stability.

Relating this analysis to specific PFM functions suggests three key elements: timely and reliable information on the fiscal and financial position of government; a basic understanding of the overall debt position of the government; and maintaining awareness of key fiscal risks. Governments would need to have systems in place to track their expenditure in-year to ensure they are broadly on target for whatever deficit they have planned for. This would provide information for budget decision-makers regarding the overall spending trajectory compared to plan, and provide warning and inform options for action if expenditure was not on course. Similarly, the right information on the government's overall debt position now, key trends over the preceding years and forecasts for future years will provide the right information for decision-makers to feed into immediate in-year spending decisions, and for future fiscal policy decisions. Without an understanding of the government's overall medium-term debt position, current in-year spending information is an incomplete guide as to whether overall, fiscal deficits or surpluses are sustainable and desirable. Finally, effective management of the government's fiscal position and resulting deficit would require an understanding of the size and likelihood of key risks to the budget. In capacity-constrained Pacific Island countries, this might be changes in key commodity prices, unexpected liabilities accrued by state-owned enterprises, or risks of non-disbursement of expected funds from donors. Such awareness will allow decision-makers to approach expenditure choices more intelligently in terms of what challenges or opportunities might occur.

In all cases, PFM systems cannot, by themselves, ensure that the correct decisions are made regarding macroeconomic stability. PFM systems can contribute to achieving macroeconomic stability through their ability to provide the right information to budget decision-makers on governments' expenditure positions, debt sustainability and fiscal risks. However, as noted above, is it political incentives that will determine whether this information is used to make – and stick to – expenditure decisions that have a positive impact on macroeconomic stability.

2.2 Links between PFM and resource allocation

Contemporary theoretical literature on the allocation of public resources derives substantially from seminal work by Musgrave (1959; 1989). In his framework for evaluating public expenditures, Pradhan (1996) follows the principle that 'the composition of public expenditures should finance the mix of goods and services that maximize social welfare'. However, he acknowledges that it is infeasible to apply this test of allocative efficiency fully in practice. He also acknowledges the relevance of institutional arrangements for public expenditure management in the economic analysis of public expenditure allocations, notably the role of formal and informal rules. Schick (1998) further develops this relationship by addressing allocative efficiency in terms of 'the capacity of government to distribute resources on the basis of the effectiveness of public programs in meeting its strategic objectives'. This framing is consistent with the focus of the World Bank Public Expenditure Management Handbook (1998) on strategic resource allocation, and is summarised by Brumby (2007) as 'interventions which are consistent with the priorities of society, as represented by decision-makers'.

Resource allocation is usually considered a direct outcome of improved PFM systems and processes. A standard objective of reforms related to policy-based budgeting and inter-sectoral budget credibility is the achievement of greater allocative efficiency. However, there are major definitional and methodological challenges to the analysis of 'efficiency' in expenditure allocations. Efficiency can be a purely technical term if analysed econometrically or statistically as a 'rate of return', or another such measure of impact per dollar spent. PFM reforms can target improvements in the efficiency of expenditure allocation by making such decisions more transparent, evidence-based and subject to rigorous challenges; however, there may be no objective answer to the question of which allocations are more 'efficient'. Budget allocations are also inherently political and the value of any particular investment may not be objectively determinable.

The question of 'efficiency' and 'value' of different expenditures therefore needs to be connected to a politically determined expenditure strategy outlined by a government with a legitimate mandate. In this strategy, the political leadership will set out its priorities for expenditure and ambitions for delivery of certain outputs and outcomes. From this strategy, a budget policy setting out the overall level of expenditure expected and the relative priority of competing spending claims can be derived. This budget policy, combined with information from more technocratic econometric analysis, can then answer some of the issues regarding the 'efficiency' of allocation. In many countries, the Poverty Reduction Strategy Paper and/or associated 'national development strategy' can provide the guide to political priorities, and thus different values attached to different spending sectors, from which a budget policy that reflects these priorities can be drawn. Clearly, this would represent an ideal situation which may not be obtained in many developing countries. Notably, governments may not always have a legitimate mandate to put forward a national development strategy from which a budget policy may be derived in order to answer the question of relative value of expenditures. Equally, national development strategies may not be fully 'owned' by the political elite and may perform a number of functions, not least satisfying donor expectations rather than genuinely expressing the government's public policy priorities. Nevertheless, efficient allocation requires some form of political input into the process in order to guide judgements regarding the relative value of different expenditures.

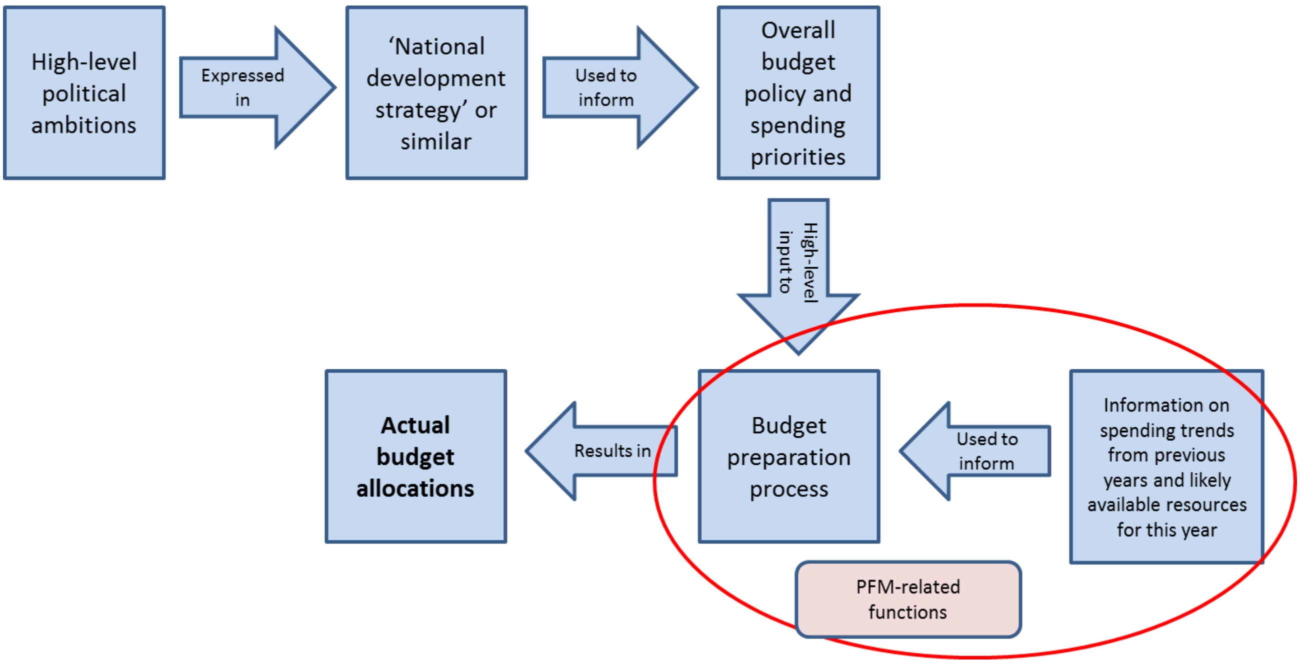
At a conceptual level, well-functioning PFM systems provide the tools to support more efficient resource-allocation decisions in two main ways: information and process.[1] PFM reforms can be expected to directly and substantively improve (1) the provision of accurate, timely and relevant information, and (2) the structured framework for identification, analysis and negotiation of competing options of resource allocation in light of the national strategy. If PFM systems can credibly forecast, track and report on revenues and expenditures, these processes will provide information and data to decision-makers on available funds and on the costs of

[1] See also Brumby (2007) on institutional design factors and information factors.

competing priorities to inform budget policy. Good PFM supports well-informed decision-making on resource allocation and permits judgements about welfare-maximising (i.e. efficient) allocations (Fozzard, 2001). Beyond the information itself, PFM provides a structured framework for identifying, analysing, comparing, selecting, implementing and evaluating options for expenditure allocation across sectors, agencies and programmes, in light of the political value placed on different sectors. Most obviously, this is done through an annual budgeting process.

The PFM system cannot, by itself, ensure that efficient allocations are actually made or adhered to by political decision-makers. The link between PFM systems and efficient allocation assumes that technical systems and processes that generate information for spending decisions are followed up by political decisions that are similarly 'efficient'. This may not always be the case. In the literature on PFM in Pacific Island countries, analysts have noted that while PFM systems can deal with failures of *information* regarding allocation decisions (i.e. making sure that accurate information on expenditure priorities is available for decision-makers), this cannot compensate for a failure of *political incentives* to make, and stick to, efficient allocations (Laking, 2010). Reliable fiscal and financial information and a well-structured and consultative budget process are necessary, but insufficient, conditions to ensure the efficient allocation of public resources.

Figure 1: PFM and the resource allocation process



Source: authors

Although more efficient allocation is held as a direct outcome of improved PFM, it is rarely analysed as a separate or even leading objective of reform. Most PFM-reform programmes are multi-layered and focus on a number of interrelated reforms, not simply efficient allocation issues (e.g. Andrews, 2010; Lawson, 2012). The literature does not provide much information on which *specific* PFM reforms are theorised as useful for increasing the efficiency of allocation. In synthesis studies of PFM reform, the issue of efficient allocation is rarely split out from all other aspects (World Bank, 2012; de Renzio, 2009).

Political incentives of spending and patronage are often stronger than technocratic PFM systems. Related to the above, several studies of budgeting practice in fragile or low-income contexts note that the political reality of these environments, particularly the need to maintain patronage networks, undermines processes of budget allocation and execution (see Hedger, 2011; Rakner et al., 2004). In some Pacific Island countries where populations are very small and skilled labour is in short supply, civil servants, ministers, donor staff and external contractors are often well-known, and even related to each other, making issues of patronage even more challenging. At its most extreme, sophisticated budget-formulation processes that target 'efficient' allocations risk being nothing more than paper exercises undertaken during budget planning.

External policy conditions by development agencies may have a stronger direct effect on resource allocation than PFM reforms. The latter target allocative efficiency only indirectly through institutional strengthening. For example, budget-support operations typically include conditionality that relates to budget composition (e.g. a certain percentage of spending on particular sectors). PFM reforms may help enable these conditions to be implemented, tracked and reported against, but it is the donor policy conditions that drive the allocation in the first place, and not PFM reforms.

The cross-country evidence suggests that efficient allocation decisions, corresponding budget credibility and multi-year budgeting remain challenging areas for improvement in fragile states. Recent evidence from a study of eight fragile states undertaking PFM reform suggests that advanced budget preparation processes (through which allocation decisions would be made) and budget credibility (through which they would be adhered to) have made relatively limited progress. Political incentives and donor conditions can be more influential than PFM systems in driving allocation decisions. It can be difficult to determine whether poor results are due to a failure of information and weakness of process (which PFM reforms can directly improve) on the one side, or to a failure of incentives (over which PFM reforms have only indirect influence), on the other. Given these challenges, it may be that in capacity-constrained environments, a budget policy that sets allocations broadly in line with the national development strategy, and that can command some support among ministers, is 'good enough' when it comes to efficiency of resource use.

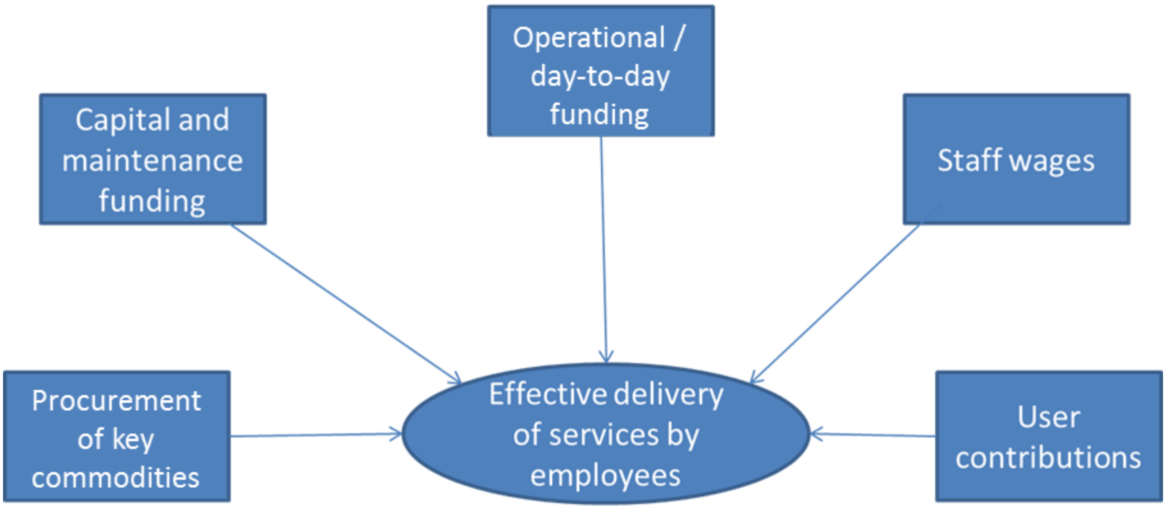
The theory and evidence reviewed above suggest two basic PFM functions to maximise the likelihood of efficient allocation of public expenditures: timely and reliable fiscal and financial information; and a well-structured budget preparation process. Reliable fiscal and financial information will provide the basic figures for official and political decision-makers to use in constructing a budget policy derived from the national development strategy. Incorrect, incomplete and/or untimely fiscal and financial information will make it difficult to develop an effective budget policy and make sensible allocation decisions, even if the technical and political elite are fully behind such an effort. In terms of the budget preparation process, a method that effectively engages spending agencies at a technical and political level increases the chances that the right information will be fed into decision-making procedures to inform an efficient allocation. A well-run process that engages all stakeholders will increase the chance that key actors will have bought into the budgeting process and that, as a result, government will adhere to the agreed budget.

This is a departure from some of the 'standard' prescriptions for PFM functions that will improve efficiency in resource allocations. For some PFM practitioners, some variant of 'programme-based budgeting' or 'performance budgeting', where budget processes aim to explicitly link budget allocations to outputs and outcomes delivered, offers the best chance for increasing efficiency of allocation. Through such an explicit link, it is easier for budget decision-makers to judge relative efficiency of spending (i.e. the relationship between budgetary inputs and service outputs) both between spending areas and over time in the same area (World Bank, 2010a). However, the ability of capacity-constrained governments to manage such complex processes is not clear. In the case studies recently reviewed by the World Bank, it was found that programme-based budgeting, along with other more complex reforms such as medium-term expenditure frameworks (MTEFs), did not achieve great impact (World Bank, 2012a). As a result, given the focus of this discussion on capacity-constrained contexts, reforms aimed at delivering sophisticated tools such as programme-based budgeting or its variants do not seem an appropriate ambition.

2.3 Links between PFM and service-delivery agencies

It is widely theorised that improved PFM systems will have a positive *indirect* effect on service delivery. For example: 'Better payments systems and better cash management make it more likely that payments can be made on time, including for wages, transfers, operations and management, and investments' (World Bank, 2012a: 51). The effect can be said to be *indirect*, given the wide range of other factors that will impact on service delivery. Again, the literature on the determinants of effective public-service delivery in developing country contexts is large, but Figure 2 demonstrates a simplified view as to how PFM-related inputs will contribute to service delivery.

Figure 2: PFM-related contributions to service delivery



Source: authors

Each of these contributions will have a link to government financial systems in some way. Provision of operational, capital/maintenance and staff-wage funding is typically a core role of government systems. User contributions represent external finance, but government PFM systems will have a role only in collecting and accounting for them. Similarly, key commodities (e.g. textbooks, drugs) may be allocated to service-delivery units on the basis of administrative decisions, rather than market purchase, but it is likely that, at a central level, government PFM systems would be involved in their timely and effective procurement.

The diagram suggests that PFM systems are therefore important contributors to delivery of public services. Certainly, the absence of staff wages, key commodities, and operational and capital/maintenance costs would reduce the likelihood of effective service delivery. As a result, improvements to PFM systems relevant to these areas could be expected to lead to an improvement in performance to some degree. Indeed, some of the summary literature notes that in this 'conventional' view failures of public-service delivery in developing countries are typically due to weak capacity (McLoughlin and Batley, 2012), suggesting that improvements in weak PFM might lead to a similar improvement in public-service delivery.

Different public services will require a different 'mix' of these inputs. Certain public services, for example road construction, may require very little in terms of staff salaries, perhaps just enough to pay for the road authority personnel. However, road construction will require significant capital funding to pay for the road building, and a strong and effective procurement function to contract these activities with construction firms. On the other hand, health services may require a substantial salary input to pay health personnel throughout the country, effective procurement of key commodities and day-to-day operational funding; but require relatively less by way of significant capital investment. The key PFM functions that might contribute to effective service delivery may vary substantially between different public service sectors.

However, and looking more widely at the service-delivery debate, much of the literature on blockages to effective public-service delivery does not particularly identify PFM-related issues as a singularly important challenge. Much of the recent discussion on service delivery in developing countries focuses instead on higher-level institutional, incentive and political failings that undermine effective service delivery (World Bank, 2004). In this view, political institutions determine incentives for – and therefore likelihood of – public-service delivery (Harding and Wantchekon, 2010) and what might appear to be 'technical' issues affecting public services are due to underlying incentive structures.

The literature suggests that even if all PFM-related components of public-service delivery are provided on time and in full to service-delivery units (perhaps by external actors), there is still no guarantee of effective service delivery, given underlying incentive problems. For example, it may be politically more effective to withhold certain public services from certain groups (Collier, 2007 in McLoughlin and Batley, 2012), and staff may not face any incentive to actually use the resources at their disposal to deliver effective public services (Pritchett and Woolcock, 2004). Some empirical research looking at the experience of donor support to sectors noted that while Sector Wide Approaches (SWAps) and sector budget support can improve the financing of inputs into service-delivery systems, they are less effective at tackling issues of the 'missing middle' affecting the front-line of delivery, such as effective human-resource management and the actual quality of service delivery (Williamson and Dom, 2010).

If this is the case, then the absence of PFM systems capable of providing basic financial inputs (e.g. operational costs, staff wages, key commodities) will likely have a negative effect on service delivery; but the presence of effective PFM systems is no guarantee of effective service delivery, given institutional incentive issues. The absence or presence of effective PFM systems is itself likely to be determined by these institutional incentive issues.

There are very few empirical studies that attempt to find a demonstrable relationship between service delivery and PFM reforms in capacity-constrained environments. A recent World Bank study reviewing eight case studies of fragile states undergoing PFM reform reviewed whether there was any link between PFM reform and service delivery in selected sectors (World Bank, 2012a). The findings suggested little correlation between the two, although they did find an association between improved PFM systems and improved regularity of wage payments by the government. Given the labour-intensive nature of many public services (e.g. health, education) this may suggest that PFM improvements could have a particular impact on service delivery through regular payment of salaries, and that perhaps there would be a subsequent improvement in staff motivation and morale. However, this tentative conclusion must be considered in the context of the higher-level political incentive issues discussed above.

In reality, many PFM reform packages are directed, at least in the early stages of recovery from fragility or in situations of low capacity, at 'upstream' measures that will allow for central overall management of total expenditure by the ministry of finance (Di Renzio, 2011; World Bank, 2012; Andrews, 2010; ODI, 2007). These reforms will allow for the possibility of more regular transfer of funds to the relevant service-delivery ministries, but this does not guarantee that funds will then reach delivery units, or that other factors promoting effective service delivery will be in place to incentivise proper use of these funds to deliver quality services. As a result, 'standard' PFM reform packages that focus on upstream ministry of finance control maybe unlikely to materially impact on service delivery, given their central focus.

A further explanation for this inconsistency between the theorised positive relationship between improvements in PFM and improvements in service delivery may relate to the actions of donors. In many countries with weak financial systems, donors will actively use NGOs or other off-budget delivery mechanisms to deliver their objectives on service delivery. Improvements in service delivery will therefore take place as a result of donor investment outside government systems. This would likely lead to a circumstance where weak PFM systems are in evidence alongside improvements in service delivery.

From the discussion above, it seems that there are few PFM functions that can be strongly linked to positive improvement in service delivery outcomes. The discussion suggests that *absence* of adequate PFM functions in those areas that contribute to service delivery may have a *negative* impact, but identifying a strong *positive* contribution that PFM functions can make is difficult. This may lead to a recommendation that a large number of PFM functions needs to be addressed to avoid a negative impact on service delivery. However, this discussion is taking place in the context of capacity-constrained environments, and therefore a reform programme attempting to improve such a wide-ranging list of PFM functions may not be appropriate.

Regular payment of salaries and wages to staff engaged in delivering basic services is a PFM function common to all public services and could be considered the highest priority PFM focus area in a capacity-constrained environment. Payroll management is a more discrete PFM function and therefore might be easier for capacity-constrained governments to engage with than a long list of all service delivery-related PFM functions, as represented in the diagram above. All public services will require some form of human resource capacity to function even if their delivery mechanism is, in fact, very capital intensive (for example road construction). As noted, in certain sectors, for example health and education, staff inputs are critical and form a large part of the delivery mechanism. Ensuring regular and correct payment of wages to front-line staff, which appears an achievable outcome in fragile states according to evidence from the World Bank study reviewed above, might offer a highly prioritised method of using PFM functions to contribute to service delivery outcomes.

Beyond salaries, the choice of priority sector should determine PFM functions. In a capacity-constrained environment, it may be more effective to determine which sectors are considered a priority in the first instance and then review the delivery mechanism as a starting point to map requirements back to the supporting PFM functions. It is beyond the scope of this paper to provide a sector-by-sector guide as to which PFM functions are most important for each public service. However as noted, certain public services that are labour- and key-commodity intensive and require little capital input (such as health and education) will require different PFM-related inputs compared to road building or electricity provision, which are less wage intensive but require much more procurement capability and capital expenditure. Determining priority sectors and considering their delivery mechanism in relation to PFM functions would provide a starting point for designing a service-delivery oriented PFM reform programme, beyond an initial focus on paying salaries.

2.4 Links between PFM and state-building

In political science, there are numerous accounts of how states came about in different historical contexts, embedded in theoretical arguments. Some of these have been picked up by the development policy community and employed to understand contemporary states. The most prominent account was put forward by Tilly, who stated that today's states grew out of a mutually reinforcing process of the needs of warfare, which led to ever-rising taxes, which in turn eventually prompted increasing accountability to taxpayers (Tilly, 1992). The observation that the nature of a state's tax regime strongly influences governance goes back to Schumpeter, and has been applied by Moore to contemporary developing countries (Schumpeter, 1918; Moore, 2003). The detrimental effect of not needing to tax one's own citizens, mainly in the context of natural resource wealth, has been much debated in economics and political science (Ross, 1999; Collier and Hoeffler, 2005).

Regarding the development of expenditure institutions, the literature is much slimmer. There is a presumption in the fiscal-states-are-tax-states literature that taxpayer accountability leads to better-run governments, but there are not many explicit discussions covering the precise mechanisms. It is an old observation of Weber that external competition led states to pursue stability and control domestically, which eventually produced rational bureaucracies (Weber, 1980 (1921)). North, Wallis and Weingast pose that fragile states are limited-access orders, in which resources are distributed to narrow elites (North, Wallis et al., 2007; 2009). One may assume that there is much less of an incentive to develop strong public-expenditure institutions in such states, as opposed to open-access orders. In early modern Europe, however, strong control-based fiscal institutions did develop in tandem with powerful tax states, whereas accountability and allocative institutions only followed the establishment of democracy (Krause, 2013a).

There is no systematic analysis available that studies precisely how different elements of PFM relate to the formation of states, let alone how the deliberate strengthening of PFM systems could further state-building. In practice, development agencies rely on reasonable assumptions about the relationship between PFM and statehood. Some degree of basic PFM capability is impossible to disentangle from the existence of the modern state as an entity – it is in fact part of the very definition of what makes a state modern. Without some form of ability to raise a minimum level of revenue and then disburse this in pursuit of government aims (however limited) a state cannot truly exist. PFM reforms that allow for basic raising, allocation and disbursement of funds are directly supportive of state-building.

PFM systems allow the government's intentions for public policy to be realised, and thus to build legitimacy. The legitimacy of the state relies to some extent on pre-existing loyalties and the belief in the rightness of order being maintained by it (Weber, 1980 (1921)). But this 'input legitimacy' is inexorably connected to 'output legitimacy', the ability of the state to provide goods and services that citizens want. A bureaucracy capable of doing this relies on the flow of public funds (Scharpf, 1997). In principle, functioning PFM systems should allow for stabilisation and confidence-building measures in very fragile contexts. The ability of government to deliver some basic services and, crucially, pay public-sector salaries is a stabilising and confidence-building mechanism in fragile contexts (ODI, 2007).

Adequate and/or improving PFM systems that are recognised by other international actors can build state credibility. The OECD state-building guidance notes the importance of fragile states being recognised and supported within the international system. If PFM systems are not up to a certain level then donors – often crucial in a fragile setting – will use other delivery mechanisms outside the state's systems. This can undermine a state's credibility in the eyes of its own citizens and have a negative impact on state-building (Manuel et al., 2010).

Turning the empirical observations of the state-formation literature into normative guidance, some donors suggest that PFM measures focusing on revenue can have a state-building effect through generation of a social contract (DFID, 2009). This optimistically assumes a particular direction of causality, in the sense that the imposition of taxes in return for services will eventually lead to legitimacy and oversight. Revenue-raising appears as a significantly more important PFM function in the state-building literature than public spending. In contrast, the 'regular' PFM literature focuses more on effective disbursement of public funds.

A focused and realistic view on state revenues seems more appropriate. If the most basic objectives for states is survival (Waltz, 1990), then having a viable revenue base and exercising control over it is a critical element of statehood. Without revenues to fund its activities, no state can survive for long. In the long run, in most countries, that means the state must develop the capacity to extract taxes, by force if need be.

Some suggest that effective PFM contributes to accountability, democratic responsiveness and legislative oversight of the state's functions. Several practitioner handbooks and briefing notes on PFM (e.g. SIDA, 2007) suggest that state-building requires accountability of the state, in some form, to its citizens. Some of these documents link PFM reforms to improvements in accountability (e.g. better audits, legislative scrutiny of spending, civil-society participation in the budget process), which is hoped to have a positive state-building effect.

There is little 'unpicking' of the specific contributions that individual elements of PFM can make to state-building, and a risk of assuming that 'all good things go together'. The World Bank recently noted 'little granular unpicking of the specific' contribution that PFM makes to state-building (Fritz, Fialho Lopez et al., 2012). This included a lack of clarity as to where PFM is a substantive contribution to state-building in its own right, and where it is instrumentally useful in supporting other state-building elements, such as service delivery. Suggesting that PFM reforms and effective management of resources have a positive impact on accountability, transparency and even human rights realisation (SIDA, 2007) is not always accompanied by a clear theory as to how this would happen, what conditions must obtain, and which PFM sub-systems are important for these issues.

There are instances where PFM reforms might have a negative effective on state-building. Following North, Wallis and Weingast, in contexts featuring fragile ruling coalitions, held together by the prospect of accessing illegitimate rents, strong and externally imposed PFM controls could undermine the elite political settlement in a single-minded pursuit of better PFM systems. PFM systems heavily supported by donors and external technical assistance, which are seen to respond to donor requirements in the context of weak state capacity, may undermine confidence and legitimacy in the emerging state; although this is as much a criticism of the impact of poorly designed technical assistance as it is a criticism of the relationship between PFM and state-building.

The empirical evidence regarding the relationship between PFM and state-building in the literature is less extensive than historical analyses, theory, and especially, largely normative policy literature. Agreed and objective measures of capable, legitimate and sustainable states are not available, and sound quantitative analysis relating these to PFM improvements is not easily done.

A recent World Bank study on PFM reform in post-conflict countries finds that improvements in PFM generally match improved state capacity (a key measure of state-building), but the direction of causality is unclear (Hedger, Krause et al., 2012; Fritz, Fialho Lopez et al., 2012). Causation between the numerous interlinked components of state-building does not allow for 'PFM reforms' to be easily singled out. It is likely that if a government is motivated to undertake serious PFM reform it is probably also interested in a range of other state-building measures (ODI, 2007). The case studies support the view that the context of fragility leading to state-building is vital in understanding and predicting PFM reform. For example, the Government of West Bank and Gaza made improvements in PFM as part of a state-building strategy to demonstrate to the international community that it could be a competent state (Krause, 2012); conversely, less progress was made in DRC, which lacked a similarly strong motivating incentive for PFM improvement (Baudienville, 2012).

The country cases support the idea that the development of a functioning budget goes hand-in-hand with state-building. The case studies in question show most consistent cross-country improvement in key aspects of basic budget execution (e.g. establishment of Treasury Single Accounts, cash management, financial management information system (FMIS) variants) often focused on increasing control at the centre through the ministry of finance. More advanced reforms looking at improving budget preparation, for instance, were generally less successful. The accountability aspect of PFM reform was a weak area of progress. This suggests that the links between PFM and accountability, transparency and democratic control may be more nuanced than the policy literature suggests. Starting from the point of the key propositions the literature has generated, the following groups of key functions could be tentatively put forward as the basis for informing a state-building-related PFM reform programme.

As a result, 'basic budgeting', in the sense of expenditure control and execution ability, should be a priority in terms of using PFM functions to contribute to state-building. What this means in terms of each country context may vary, as noted above, depending on starting points, appetite for reform, and resources available. At a straightforward level, it could mean that government has a broad understanding of the likely revenues expected, and their source, for the current year and for the next couple of years. Similarly, basic budgeting would entail a broad understanding of the envelope for expenditure as a result of these revenue flows for the current year, and a likely trajectory for the next couple of years, alongside a sense of the political priorities that the government wishes to see translated into budget policy decisions. This would also mean an understanding of the fixed costs that must be met each month, quarter and/or year – at least in the largest ministries – giving a sense of the resulting discretionary resources available. Basic budgeting might also mean an understanding of the most significant multi-year commitments government has already made (for example through key infrastructure projects) and being able to plan for these in annual budgets. Basic budgeting could mean an understanding of a likely pattern of cashflow through the year, including peaks and troughs in cash availability, and how that matches up with cash demand, at least for the largest ministries and highest priority expenditures.

The discussion would also suggest that PFM functions enabling the regular and timely payment of public-sector salaries can contribute a state-building effect. Leading from the above discussion, this would suggest attention being given to PFM functions that aim to support basic payroll management. This would mean systems that can accurately forecast the government's wage bill to feed into the budget allocation process. Following on from above, it would mean decision-makers having an understanding of the minimum cashflow required to pay salaries each month, and matching this against cashflow availability in monthly or quarterly funding releases. It would also suggest that budget decision-makers take an interest in ensuring that there are sufficient controls on additions to the payroll, and that payment systems from the central bank down to the individual public sector worker are robust enough to ensure delivery of salaries on time, with minimum leakage and error.

PFM reforms aimed at providing government with an understanding of the revenue base and options for expansion in the future could contribute to state-building in the longer term. This may be the least straightforward PFM function to deliver, and will depend a great deal on the structure of the economy (e.g. a significant natural resource sector, or reliance by the state on general taxation) and nature of the current social contract between government and wider society. At a basic level, PFM reforms can help provide information on the current major sources of domestic revenue to government, their relative change over recent years, and future projections. PFM systems could help show where the tax burden falls currently, and in doing so highlight areas where obligations could be extended to widen the revenue base in order to achieve the desired social contract and accountability pressure over time.

2.5 What is to be done?

It is possible to draw some high-level tentative conclusions on the nature of this prioritisation, but these should be viewed as suggestions for further discussion and will always have to be contextualised. Much of the analysis has involved multiple sources of evidence and the application of judgement to draw out links between them. As a result, other analysts might interpret sources differently and prioritise a different set of links between development objectives and PFM functions. Some commentators might reject the notion that accountability and audit-related PFM functions, which do not feature below, could ever be a 'non-priority', perhaps on principled grounds. As noted, this analysis has assumed a capacity-constrained environment, and therefore applying it to situations of higher capacity would likely also result in a different list of PFM functions that could make a contribution to delivery of the stated development objectives.

Table 1: PFM functions and development objectives

Development objective	Priority PFM functions identified as contributing to development objective
Macroeconomic stability	• Timely and reliable fiscal and financial information • A basic understanding the overall debt position of the

	government • An awareness of key risks to the fiscal position of the government
Efficient allocation of resources	• Timely and reliable fiscal and financial information • A well-structured budget preparation process
Service delivery	• Regular payments of salaries and wages to staff engaged in delivering basic services • Beyond salaries, the PFM functions to be prioritised will depend on the nature of the priority public service sectors chosen
State-building	• Basic budgeting in the sense of expenditure control and execution ability • Regular and timely payment of public-sector salaries • Understanding of the current structure of the revenue base and options for expansion in the future

In many ways, the above tentative list represents a prioritisation of a basic credible annual budget and the major risks to it, awareness of debt and cashflow dynamics, and a focus on managing the public sector payroll. A focus on putting in place the 'bare bones' of budgeting – of which the above is an approximation – is where many of the fragile states in the World Bank case-study series focused their efforts, and had most success. This might be a tentative piece of evidence, that in fragile-state contexts, represents a realistic set of priorities.

This set of tentative reform priorities would likely suggest a series of reforms that the ministry of finance is well placed to lead. For example, a focus on a basic budget would suggest: reforms like Treasury Single Accounts; some form of FMIS with the ability to track and stop ministry spending when above budget; development of a simple monitoring tool of public enterprises and payroll risks; and basic cashflow monitoring. These could all be led, or done, by the ministry of finance. An agenda that relies solely on the leadership of the ministry of finance comes with potentially crippling limitations – as observed by Andrews (2009, 2013). Reforms that do not engage peripheral actors are less likely to lead to better outcomes. However, for the ministry of finance to lead on a set of relatively basic, but potentially quite powerful, changes, may have a better chance of creating momentum and engaging other actors. As such, the items discussed here are distinct from the more symbolic budget reforms such as MTEFs, performance budgeting, or accrual accounting, that serve as signals to the donor community (Andrews, 2013), but have been shown to usually fail in severely capacity-constrained contexts (Hedger, Krause, Tavakoli, 2012).

In practice, these recommended PFM functions are heavily interlinked and could not be approached in isolation. The functions identified would not easily lend themselves to a set of reforms where individual reform actions are clearly linked to individual functions. Reforms to improve a government's understanding of its in-year fiscal position would likely require changes to a large number of government systems, not one simple change. Translating these key PFM functions into a reform programme is not straightforward and would require significant thought to map existing government systems and available capacity against each reform priority.

These conclusions sketch out the key functions that could be considered part of a PFM reform programme aiming at contributing to the four development objectives, but they do not provide detail on the correct 'depth' of reform. To reiterate the point already made, the list of PFM functions here identifies areas where a reform-minded government could consider focusing its attention to maximise the contribution that PFM can make to the four development objectives. The analysis and its conclusions have little to say regarding the depth, sophistication and precise nature of a reform programme that might be drawn from the identification of these PFM functions. This will be heavily dependent on the local context.

Ultimately, no discussion of possible reform priorities and links between actions and outcomes is going to replace the importance of country context and reform focus. The links discussed in this section can contribute to a conversation about which some actions are more important than others, given a set of reform priorities. It relies on the premise that some elements of PFM reform will always be more important to governments, and that even a medium- or long-term reform agenda is not just derived from an assessment of how a country's PFM system falls short of an idealised OECD best practice standard.

3 Enhancing capacity in the context of PFM reform

There are two broad responses to severely capacity-constrained environments: to rigorously prioritise reforms; or to increase capacity to be able to do more. The preceding section discussed ways to think about the first part of the response – how to identify the goals of PFM reforms and select reform priorities accordingly. Given the uniformity of global PFM reforms and the sheer volume of reforms attempted simultaneously in many countries (Andrews, 2009), prioritisation is likely to be a useful exercise in many cases. However, in situations of dire need, or where capacity is severely limited either permanently or for a very long time, direct action to deal with capacity needs is going to be almost inevitable.

This section addresses the question of how to approach capacity enhancement in highly capacity-constrained contexts, notably contexts that face profound and structural constraints in the level of their human capacity for public financial management. The analysis proceeds in five steps:

1) We classify in a basic taxonomy the standard forms of capacity enhancement applied in severely capacity-constrained contexts, such as post-conflict states and low-income countries.
2) We review the underlying purpose of these capacity-enhancement efforts, beyond the simple objective of increasing human capacity in the public sector.
3) We consider the change theories implicit in the standard and more ‘innovative’ approaches to capacity enhancement.
4) We review the evidence and lessons on success factors for capacity enhancement in relevant contexts, such as post-conflict states and low-income countries.
5) We set out some possible options for capacity enhancement in Pacific Island countries.

The present section examines the merits of existing approaches used to expand a government’s capability through external support for capacity enhancement. Increases in capacity will permit increased scope and ambition in the development objectives set by a government, to the extent that this capacity persists and is durable. As noted by recent studies, capacity is only one facet of the more holistic concept of capability (Brumby and Dressel, 2010). However, it is an irreducible core requirement.

3.1 Standard forms of capacity enhancement

Definitions of capacity enhancement are manifold and usually imprecise. A large number of different activities may be considered or claimed as capacity-strengthening interventions. Here we focus exclusively on external support for capacity enhancement, both direct and indirect. Standard guidance by development agencies suggests three distinguishable approaches: ‘capacity building’ (training); ‘capacity supplementation’; and ‘capacity substitution’ (cf. World Bank, UNDP and bilateral agencies). The first of these is sometimes used itself as the generic category. In this paper, we apply a more limited definition.

Capacity building (training) is defined as the process through which individuals, organisations and societies obtain, strengthen and maintain the capabilities to set and achieve their own development objectives over time (UNDP, undated). Some writers note that ‘traditionally’ this has focused on a four-stage approach: (i) improving the legal framework; (ii) changing the institutional architecture; (iii) building operational systems and human capacities; and (iv) building the control and disciplinary arrangements (Porter et al., 2011). Some parts of the literature treat capacity building in this manner as an umbrella term that would include capacity supplementation and capacity substitution, provided they aim to ultimately build local capacity. Other parts of the literature see capacity building as meaning interventions (training, mentoring, etc.) directly targeted at permanent individuals and systems working in the organisation (e.g.

AusAID, 2004) and thus conceptually distinct from ‘supplementation’ and ‘substitution’. For current purposes, we use a narrow definition that excludes approaches in which external actors boost directly or replace core staff activity. Typical modalities under this limited formulation will be training, coaching and mentoring by peripatetic external experts.

Capacity supplementation refers to interventions to fill substantive PFM advisory functions using personnel outside the usual civil service structure. Typically, these approaches will be funded partially or fully by development agencies, but they need not be externally funded to satisfy the formal definition. Examples would be the use of technical advisers on PFM reform working in finance ministries (e.g. Malawi’s Government Financial and Economic Management reform programme, with resident advisers from GiZ performing permanent advisory roles located in the ministry). Some ‘technical assistance’ (i.e. an external, often international, adviser providing guidance to national authorities) could be considered within the category, provided it remains clearly advisory in nature and does not start to assume, or substitute for, executive responsibilities. There is an unavoidable blurring of the category when it comes to the roles of specialist advisers to senior officials (e.g. economic adviser to the minister of finance), who may be considered part of the formal structure of a ministry establishment.

Capacity substitution covers the use of external personnel and/or specialists filling line positions – not advisory roles – in government or state finance agencies. More substantially, it also covers the wholesale outsourcing of an activity or function from the state to an external agent, whether private or non-profit. Standard examples of this are use of ‘audit agents’ working on contract as an institutional substitute for elements of the domestic external audit function. There may or may not be an explicit expectation that skills will be transferred to permanent staff and systems as part of the outsourcing arrangement. Most PFM capacity substitution takes the form of individual personnel embedded in finance ministries or equivalent. These individuals may be expatriates or national consultants. A well-known example is the long-term use of ‘local technical assistants’ in Sierra Leone to perform roles such as Deputy Accountant General and Director of Budget under donor-funded contracts. The critical distinction from core government staff is that an executive function is performed outside the standard civil-service staff cadres and pay scales. In some Pacific Island countries, the roles of Auditor General and Accountant General have historically often been held by long-term expatriates working within a substitution model.

Table 2: A basic taxonomy of capacity-enhancement approaches

	Capacity building (training)	**Capacity supplementation**	**Capacity substitution**
Motivation and objective	Acquisition of specific knowledge and skills by a target individual or group to boost their capability, independent of external support.	Gradual accumulation of new skills and real-time practical advice to provide improved capability.	Additional capability rapidly installed to carry out targeted functions for specific duration of the external support.
Standard features	Formal academic study or vocational training, bespoke training courses, study visits, secondments, on-the-job coaching, mentoring, etc.	Placing long-term or short-term advisers in a government entity to work alongside executives in an advisory capacity (on matters of strategy/ policy or management/ operations).	Positional - replacing a presumptive post-holder in a formal line position. Functional - outsourcing an area of activity or delivery to an external agent or authority (e.g. contracted private-sector company).

Change theory	*Training model (indirect approach)* Relevant new techniques and motivation are acquired by individuals (or cohorts/cadres of individuals) who then apply that learning in their professional roles and thus contribute to increased performance of the PFM system.	*Advisory model (indirect approach)* Strategy and policy decision-making capability in PFM is enhanced by direct roles of external specialists, but operational or executive remits are specifically not transferred beyond core civil servants.	*Executive model (direct approach)* Execution of core functions is provided by external specialists whose expertise and capability directly increase the performance of the PFM system.

In practice, the distinctions among these three categories are not clear or absolute.[2] They provide a useful heuristic device for analysing the array of possible approaches to capacity development in Pacific Island countries. What they disregard is the hybrid or evolving modes of support for capacity enhancement. Formal training is rarely provided in isolation from technical assistance and advisory services. External consultants and advisers often work alongside 'counterparts' who are themselves externally contracted and remunerated on terms distinct from the core civil service. Supplementary advisers will often also provide formal capacity-building training and may sometimes be requested by governments to assume executive functions.

Rather than analysing form in isolation from function, a more useful starting point is to consider the purposes and objectives of a particular approach in a given context. That permits an assessment of the relative efficacy of different models. It also invites evaluation of how appropriate the objectives are themselves. As discussed in the following section, the preponderant role of development agencies and donor financing in most Pacific Island countries and low-income countries complicates the objectives and motivations for capacity enhancement in these contexts.

3.2 Motivations and objectives for capacity enhancement

The explanation for external capacity enhancement is typically a diagnosis by development agencies or government that existing (local) capacity is insufficient compared to reform objectives. This lack of capacity could be due to a general deficiency in the overall management ability of government in running existing and potential future systems; it could relate to a lack of specific technical knowledge to develop and/or improve particular systems that require specialist knowledge; or a mixture of the two. Given the focus above on specific PFM functions, the analysis will assume that capacity enhancement activities are focusing on specific technical deficiencies related to PFM, rather than aiming at generic management improvement; acknowledging that in practice, capacity enhancement activities may aim at some combination of both.

This diagnosis that extra capacity is needed usually emerges in one of four ways:

- **'Demand led': the government diagnoses weak capacity and seeks help**. Intrinsic motivations stemming from a genuine and 'home-grown' desire by political and technical

[2] A good example of the blurred boundary between supplementation and substitution is the ODI Fellowship Scheme. It places junior economists in line positions in developing country finance ministries and other institutions with the aim of providing additional capacity to recipient governments. These personnel are formally employed by the government, sit within the line structure, and are subject to standard terms and conditions of employment. On the other hand, they are usually expatriates, they are selected through an international recruitment process and they receive a supplementary donor stipend for cost of living.

leaders to improve government performance can motivate reform initiatives. In addition, government can be spurred on by the prospect of gaining future (or losing current) donor flows going through government channels. The prospect of receiving financial aid and/or Heavily Indebted Poor Countries (HIPC) debt relief is seen as motivating governments to undertake PFM reform in some post-conflict contexts (World Bank, 2012a). In practice, both motivations may be in play at the same time and both would drive government to seek capacity enhancement support.

- **'Conditionality based': development agencies diagnose weak capacity and insist on improvement as a condition of other support**. This might be regarded as a more 'typical' situation. For example, DFID's policy on financial aid requires that recipient governments demonstrate an 'improving trajectory' in PFM (DFID, 2011); usually some donor funding is available for governments to access for this purpose.

- **'Supply driven': external actors effectively administer the territory and choose to bypass or rebuild PFM systems using external capacity**. In some immediate post-conflict situations, the international community responsible for the territory may effectively administer key government financial systems. While they may use some local capacity, high-level supervision and oversight will involve significant responsibility for external players. This may be because local capacity is at critically low levels (e.g. Kosovo and the role of the UN civil administration acting as the central fiscal authority immediately after the 2000 conflict), or because of a lack of confidence in local authorities by the international community (for example, Liberia and the Government Economic Management Action Plan (GEMAP) in the 1995 post-conflict period).

- '**Technologically required': certain very technical or specialised areas of reform may quite reasonably be beyond core staff capacity**. The most technical and IT-dependent reforms, such as the set up and operation of a computerised FMIS will almost certainly require externally sourced expertise. This is not exclusive to less developed countries; many developed countries will contract external (often private-sector) actors to help them implement new PFM systems and processes. Arguably, this is a different category of accessing external capacity, and one that does not directly relate to weaknesses or deficits in institutional capacity.

These motivations underlying capacity-enhancement initiatives provide a good insight into their purpose. Whether the requirement is based on government demand for better PFM outcomes, donor conditions or specifications for more robust PFM systems, or a specific technical need associated with innovation or new technology, the different forms of capacity support also implicitly have different direct objectives.

As shown in Table 1 above, those objectives are threefold and they correspond to the three approaches in the basic taxonomy:

- Capacity building (training): Acquisition of specific knowledge and skills by a target individual or group to boost their future capability, independent of external support.

- Capacity supplementation: Gradual accumulation of new skills and real-time practical advice to provide improved capability.

- Capacity substitution: Additional capability rapidly installed to carry out targeted functions for specific duration of the external support.

3.3 Change theories for 'innovative' capacity enhancement

In some severely capacity-constrained countries there are examples of a move away from traditional capacity building and training approaches towards more innovative models of capacity supplementation and substitution. In Liberia in the immediate post-conflict era, the GEMAP featured innovative 'dual controls' over expenditure alongside a mix of long-term and short-term advisory support (Hedger, 2011). Sierra Leone has made extensive use of long-term national advisers on higher donor-funded payscales to provide extra capacity in the Ministry of Finance (Tavakoli, 2012). However, is not clear that the emergence and replication of these new approaches has been accompanied by systematic analysis of the change theories underlying them, nor of the expectations about their discontinuation, transition or sustainability. For example, many capacity-enhancement initiatives in fragile states seem targeted more on short-term exigencies than long-term capability strategies. In Pacific Island countries, many development agencies are locked into near-perpetual external capacity-support arrangements without clear exit strategies (which in some circumstances may be an intentional design feature of the support provided). Both sets of cases point either to a lack of explicit change theory or to fundamental weaknesses in those that are in use.

Several factors have fuelled the dissatisfaction with traditional models of capacity building and training. These explain the experimentation with new approaches and help reveal their explicit change theories.

Some reviews find a lack of success with 'traditional' capacity building. A review of capacity building in World Bank operations in Africa concluded that '[t]he Bank has not developed a body of knowledge on what tools should be applied in different country contexts' and noted that '[t]echnical assistance has had little impact on strengthening client capacity' (World Bank, 2005). A review in 2008 found that no more than half of the $720m spent on training each year results in improved developmental capacity (World Bank, 2008). Many documents reviewing capacity-development approaches go to great lengths to note the very specific conditions that must be met if success is to be achieved (Datta et al., 2012; McKecknie, 2005; AusAID, 2004; UNDP, undated). Examples of failed or problematic capacity building are recognised in the literature (see Fyson, 2009 for a detailed case study on Ghana). Leading analysts have started to argue that the 'traditional' approach of funding externally provided workshops, adviser-led training courses, overseas study tours and overseas education in order to promote donor-prescribed solutions is unlikely ever to succeed (Pritchett, Woolcock and Andrews, 2010).

There is growing pressure to deliver 'value for money' and rapidly show results. The rhetoric and policy reforms from certain donors are pushing for a stronger focus on 'results' as a consequence of aid interventions (in the context of DFID's work, see Mitchell, 2011 and DFID, 2011; also the World Bank's 'P4R' programmes, World Bank, 2011). Traditional capacity building is widely acknowledged as a long-term process, for example in the context of the Pacific it has been recommended that design of effective capacity-building projects may require a lead-in design phase of six months to two years, while the realistic time frame for intervention is ten years (AusAID, 2004). This may be increasingly unattractive as a development intervention for certain donors who wish to demonstrate rapid and substantial improvements in capacity as a result of their interventions.

There is too little local capacity to enhance in the short-term. In post-conflict situations, ministries of finance may be so depleted in terms of human resources that there is little local capacity to work with. Where a cadre of permanent civil servants needs to be recruited and/or re-deployed into key positions, capacity substitution may be the only way to fill key gaps, at least in the short to medium term. In fragile situations, particularly post-conflict, external support may be necessary simply to 'get things done' to an acceptable level on an accelerated timescale, before longer-term capacity enhancement can be addressed (Tavakoli and Saneja, 2012).

There is little expectation of improvement in government capacity in the medium to long term in some low-income countries. One of the root causes of weakness in PFM capacity in fragile states is the uncompetitive remuneration packages available in the civil service (World Bank, 2012). In the long term, capacity-development programmes are heavily reliant on effective civil-service reform programmes that will create a permanently improved situation of higher capacity through more attractive employment opportunities for skilled individuals. Those processes are not typically an early priority and they require time to develop and implement. Governments in post-conflict situations may not have formulated a plan for dealing with skills shortages and gaps within the civil service. In the Pacific Island country context, some specialist PFM skills are unlikely to be reliably sourced at a national level and medium- to long-term external support will be necessary for certain functions (World Bank, 2010). The use of external capacity support may effectively be a semi-permanent condition in poor countries lacking an effective civil-service reform programme.

There is a lack of trust in government by donors. Lack of trust in government systems, coupled with the need to demonstrate safeguards and reform progress, can cause development agencies to require a particular form of 'capacity supplementation' designed to control and assure expenditure beyond simply providing advice. This was part of the early GEMAP programme in Liberia, with international staff having some role in authorising and approving expenditure (Hedger, 2011). Even in longer-term PFM advisory roles, donors may seek external capacity as an informal 'watchful eye' on government activities.

3.4 Evidence and lessons on success factors for capacity enhancement

There is some degree of consensus on what makes capacity building successful at a general level within the literature, including those documents directly relating to capacity building for PFM in the Pacific. Two factors predominate: (1) commitment from the partner institution to achieve change; and (2) a package of interventions designed and 'owned' by the partner institution. These are discussed in turn.

Commitment from the partner institution to achieve change. The first factor noted as critical to success is invariably a genuine willingness to reform, described variously as: 'political commitment' (World Bank, 2012a); 'strong political commitment' (Lawson, 2012); 'leadership' (McKechnie, 2004); or 'ongoing commitment by government at both political and technical levels' (IMF, 2010). Opinions differ on the scope for improvement if high-level political commitment is lacking. The World Bank suggests that political commitment can generate technical commitment, but not the other way round (World Bank, 2012a). The IMF suggests that in the absence of such commitment it may be possible for technocrats to lead reforms 'below the radar' of political notice (IMF, 2010).

A package of interventions designed and 'owned' by the partner institution. Analysis of PFM reform in Pacific Island countries concludes that the most critical success factor is 'a partner agency [that] has a very clear view (vision) of its own future' (AusAID, 2004). Other studies note that: 'country-led planning' is the first factor in designing effective capacity-building interventions (JICA, 2007); 'national ownership' is needed for successful capacity building (UNDP, undated); there is '[a need to ensure] that capacity building support is country owned' (World Bank, 2005); 'If change processes are not owned by and led by those whose capacity is being developed, they are unlikely to happen' (Datta et al., 2012).

In terms of breaking this down into more *specific recommendations* for capacity-building interventions, and reviewing material directly relevant to actual experience of PFM reforms in the Pacific, the following factors appear to underpin successful examples of reform (drawn from AusAID, 2004 unless otherwise stated).

A long-term time horizon including a substantial 'pre-design' phase. This pre-design can include up to two years of engaging with the institution at a working level, to build credibility and establish an understanding of the institution's real requirements. This involves detailed and realistic situational analysis of the institution's current and potential ability. It should go beyond 'technical' discussions of what is missing to include more contentious issues of power analysis and understanding of informal power networks (Datta et al., 2012). Timescales of 10 years should be considered as a realistic period of sustainable engagement with recipient Pacific institutions. In support of this, OECD DAC state-building guidance notes the need for a ‘long-term engagement’ strategy with fragile states if reforms are to succeed (OECD, 2011). In the Pacific context, the World Bank has proposed working from a realisation that some critical gaps will simply not be filled in even the medium to long term (World Bank, 2011), suggesting reform programmes need a similarly long time frame.

In terms of the method of delivery by the provider, capacity building and support from ‘peer’ organisations is valued, and long-term co-location of technical assistance is preferable to fly-in and fly-out advice. Interventions that used the expertise and experience of ‘peer’ government officials from Australia and New Zealand carried more credibility with partner agencies than using unaffiliated consultants. The most effective forms of ongoing on-the-job training came from co-location of long-term advisers within government offices, working on a day-to-day level with counterpart officers. This was found to build camaraderie, credibility and trust among advisers and counterparts.

On-the-job training is most effective, provided it is recognised as ‘training’ by recipients, while capacity building across whole teams and training many individuals on several different tasks can avoid negative impacts from staff turnover. When assistance is offered, it is necessary to be clear that mentoring, informal coaching and day-to-day sharing of experience constitutes ‘training’, to ensure that the work has its desired impact. There is often a clear desire on the part of capacity-building recipients for out-of-country tertiary study, but this may not be in the best interests of the long-term capacity development of the host institution. In terms of sustainability, it was noted in the case of several projects in the Solomon Islands that training an entire team on many different tasks reduced the risk that one individual’s exit would result in the loss of all skills (Bailey, 2009).

In terms of management and oversight of the intervention, the most successful interventions featured clear benchmarks for partner-agency performance, and flexibility in terms of the nature of the capacity to be built. Clear and mutually agreed expectations of partner-agency behaviour allowed for mutual accountability and needs to be accompanied by credible threats of withdrawal of support if the necessary commitment is lacking. The favoured approach regarding specific outputs was that long-term goals would be outlined and agreed, but the granular outputs, for example those required in a log-frame, should be left as unspecified as possible to allow for capacity building to respond to changing circumstances.

3.5 Capacity-enhancement options for severely capacity-constrained countries

There are a number of possible approaches to capacity supplementation and/or capacity substitution, some of which are listed below. Note that the following discussion presents high-level options. A full evaluation of the cost, benefits and real-world experience of the impact of each option is beyond the scope of this paper.

Choosing the ‘right’ capacity-strengthening intervention will naturally depend on the reason why capacity is required, and a mix of interventions might be needed for certain situations. For example, where an institution is committed to reform and is capable of engaging in long-term development of staff and systems, but has some immediate critical capacity gaps that are undermining basic systems, an intervention combining long-term ‘traditional’ capacity-building alongside immediate capacity substitution, through deploying long-term donor-funded staff on a rolling basis, might be necessary. 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 could be used.

3.5.1 Capacity substitution

Using computerisation as a substitute for low capacity. In some low-capacity contexts, computerising manual accounting and cash-management functions (perhaps through an outside agency) might allow for more accurate control by central agencies, and faster reconciliation and reporting of government transactions. This might reduce some instances of inappropriate use of funds and increase the chance that the correct fiscal information is available to key decision-makers. For example, donors could consider funding an external private-sector company to run the accounting and cash management for government on a confidential, long-term basis. This would also be consistent with the point above that a 10-year time horizon is a realistic one for effective PFM reform.

Outsourcing 'discrete' aspects of PFM. Certain offices and functions within the PFM cycle, for example the audit function and auditor general role, could be supplied or funded by donors. This has been tried in certain contexts, for example in Liberia the Auditor General equivalent was specifically chosen to be an Liberian 'outsider' to the current political context, with his office supported financially by donors (Hedger, 2011). In the Cook Islands, the post of Financial Secretary was recently advertised internationally, with recruitment costs supported by donors, in order to attract a wider range of candidates for the role (Cook Island News, 2011). 'Outsiders' can bring high-capacity skills for immediate improvement, alongside higher trust and empathy with government counterparts, as well as the possibility of a longer-term 'demonstration effect' that could lead to more permanent institution building.

Develop cost-effective long-term (semi-permanent) capacity substitution to ensure a basic level of capacity. If there is no realistic long-term prospect of improvement in local capacity, investment might be better placed in developing cost-effective substitution mechanisms that learn from successes noted in the literature. For example, the 'ASAS' programme in the Pacific places Australian Treasury officials in Pacific Island country finance ministries for a working placement. ODI has run the 'ODI Fellows' scheme for a number of years aimed at providing additional capacity, in the form of young economics graduates, in developing-country government institutions (often ministries of finance). The United Nations Volunteers programme could be designed in such a way as to attract inexperienced but enthusiastic graduates looking for relevant developing-country work experience. Such individuals would not be expected to 'build capacity', but instead provide vital basic skills or capacity backstop in running key financial process. Using a rolling cycle of younger staff beginning their career would allow for relative cost efficiency compared to using more experienced professional consultants.

3.5.2 Capacity supplementation

Formal 'twinning' arrangements between leading regional nations' ministries of finance and/or key departments. Such an arrangement could provide a mechanism for informal and ongoing advice from counterparts who bring additional credibility to their work, given their position in similar institutions. Such advisory work already takes place, but there could be scope for a small amount of funding to regularise and institutionalise advice, learning and coaching of key departments.

Salary top-ups for civil servants to retain able individuals in key PFM advisory roles. This has been widely used in many post-conflict situations, for example Sierra Leone (Tavakoli, 2012). It can buy a degree of capacity in the short-term, and if used to supplement the salaries of national staff, it can go some way to avoiding bringing in unwanted 'outsiders' to confidential government operations. While able to support reform in the short to medium term, there are obvious long-term problems with dual pay structures of civil servants and dual accountability to donors, leading to resentment from those not receiving top-ups. This can reduce overall institutional morale and coherence in the long term and lead to over-dependence on key individuals. Whole-of-civil-service pay reform might provide an 'exit strategy' for salary top-ups, but effective pay and workforce reform in low-capacity environments is challenging in itself, as noted above.

International technical advisers recruited from neighbouring countries. Experience from Liberia suggests that in some circumstances advisers recruited from neighbouring countries can operate well in fragile PFM settings, perhaps bringing greater credibility and authority, given experience in a similar context (World Bank, 2012a).

Training of graduates from scratch through internship schemes. This has been part of the Afghan experience (World Bank, 2012a). Offering a clearer and more comprehensive career path for recent graduates, starting at junior levels with the prospect of rapid advancement, might attract good quality candidates, at least for a few years. Taken forward on a rolling and staggered basis, such a scheme could ensure a steady stream of basic-level capacity and staffing continuity to support key PFM functions, even if staff cannot be retained for the long term.

Confidential high-level advice to ministers and senior figures. Given the importance of political will in driving PFM reforms, donors could consider providing funding for special advisers to ministers and senior officials – perhaps diaspora returnees with the right skills – engaged in PFM reform. These would be chosen by the minister or senior officials responsible, rather than the donor, and their advice would be confidential. The assumption would be that sustained and context-relevant advice from a trusted expert who values PFM reform would sustain high-level commitment to better systems. However, such an approach carries risks, given the difficulty of finding the right individual and regarding the quality and nature of advice being provided.

Involve regional professional bodies for aspiration raising and as capacity-development instruments. Some studies (e.g. Lawson, 2012) have noted that regional bodies (for example, the African Organisation of Supreme Audit Institutions in English-speaking Africa (AFROSAI) on audit institutions) may be able to engage with countries struggling with PFM reform. They can provide credible advice and guidance grounded in real-world PFM experience. If particularly proactive, they could encourage countries to share experiences to facilitate peer learning from regional leaders. The International Organisation of Supreme Audit Institutions (INTOSAI) has an explicit aim in its strategic plan to offer capacity enhancing activities for national-level audit bodies. This might open the possibility for peer-to-peer learning between regional or global institutions and their national members. Donors could consider funding such programmes to be delivered by regional institutions. Naturally, the success of a regional lead in capacity supplementation would depend on the capacity and willingness of the regional institution itself to undertake this role.

Agree that donors will 'do' some parts of the government's PFM work for the foreseeable future. The literature on PFM in fragile states notes the relative lack of success of more advanced reforms (e.g. MTEFs and programme-based budgeting) where they have been introduced in low-capacity environments (World Bank, 2012a). Acknowledging this as unlikely to change even in the long-term, certain functions that are regularly carried out by donors as part of their regular work can effectively be used as a substitute for such PFM services. For example, IMF Article IV consultations, done closely with government and modified slightly, could provide a basic MTEF to guide expenditure over the medium term. The World Bank can provide some government long-term economic thinking through its Economic and Sector advisory work that can effectively substitute for a lack of government capability in these areas. Such an approach could be possible where there is a relatively high level of trust between donors and governments and where donors are willing to alter, and/or supplement, their 'standard' activities to meet government requirements.

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