PEFA, Public Financial Management, and Good Governance
This publication is concerned with governance indicators and outcomes commonly associated with public financial management (PFM) performance. Our analysis is cross-country in focus and looks at both determinants and outcomes associated with better PFM performance using data from Public Expenditure and Financial Accountability (PEFA) assessments. This first chapter provides an overview of what PFM is and why it is important, its place within the context of international development, and the relevance of the findings in later chapters to the wider debate on PFM reform.

**Importance of PFM**

**Commonly Accepted Frameworks**

The term “public financial management” has only come into common use over the past 20 years, with a coherent and compact definition of PFM surprisingly absent in the literature (Allen, Hemming, and Potter 2013). Nevertheless, the PFM system is commonly described in terms of an annual budget cycle as illustrated in figure 1.1. This annual cycle aims to ensure that public expenditure is well planned, executed, accounted for, and scrutinized. It typically centers around the following key phases:

- **Budget formulation.** The budget is prepared with due regard to government fiscal policies, strategic plans, and adequate macroeconomic and fiscal projections.

- **Budget execution.** The budget is executed within a system of effective standards, processes, and internal controls, ensuring that resources are obtained and used as intended.

- **Accounting and reporting.** Accurate and reliable records are maintained, and information is produced and disseminated at appropriate times to meet decision-making, management, and reporting needs.

- **External security and audit.** Public finances are independently reviewed, and there is external follow-up on whether the executive has implemented the recommendations for improvement.
There is also general consensus around the objectives of the PFM system. Multiple authors have framed the PFM system around achieving the objectives of aggregate discipline, allocative efficiency, and operational efficiency (see, for example, Campos and Pradhan 1996; Schick 1998).

1. The maintenance of aggregate fiscal discipline is the first objective of a PFM system and deals with the interaction between two variables: revenue and expenditure. It entails ensuring that aggregate levels of revenue and public spending are consistent with targets for the fiscal deficit and do not generate unsustainable levels of public borrowing.

2. A PFM system should ensure that public resources are allocated to agreed strategic priorities and should spur reallocation from lesser to higher priorities—in other words, should ensure that allocative efficiency is achieved.

3. The PFM system should ensure that operational efficiency is achieved, in the sense of achieving maximum value for money in the delivery of services.

Also common is the view that PFM is “instrumental” or a “means to an end” in the achievement of broader development objectives: state building, macroeconomic stability, efficient resource allocation, and service delivery (Welham, Krause, and Hedger 2013). However, while PFM does encompass the technical literature on budgeting, procurement, cash management, debt management, accounting, and auditing, a more contemporary view is that it is also part of the wider literature on systems of governance (Andrews et al. 2014). This view recognizes that PFM is also concerned with the policy-making process—that is, the interaction within and between technicians (economists, accountants, and auditors) and policy makers (cabinet members, parliamentarians, and advisers) in the formulation of fiscal policy.

This view is reflected in more contemporary definitions of PFM. For example, Cangiano et al. (2013) notes that PFM “has broadened . . . to all aspects of managing public resources, including resource mobilization and debt management, with a progressive extension to the medium to long term implications and risks for public finances of today’s policy decisions.” More recently, Andrews et al. (2014) define PFM as “the way governments manage public resources (both revenue and expenditure) and the immediate and medium to long term impact of such resources on the economy or society.” As such, “PFM has to do with both processes (how governments manage) and results (short, medium, and long term implications of financial flows).”
Introduction: What Is PFM and Why Is It Important?

The PEFA Secretariat’s definition captures much of this consensus, describing “good PFM” as “the linchpin that ties together available resources, delivery of services, and achievement of government policy objectives. If it is done well, PFM ensures that revenue is collected efficiently and used appropriately and sustainably” (PEFA Secretariat 2016).

At the same time, this framing remains ambivalent on the design of revenue and expenditure policies whose evaluation is generally left to those working in other fields. There remains a distinction between the field of “public finance,” which focuses on “what to do” questions of policy, and “public financial management,” which focuses more on “how to do” questions of implementation (Allen, Hemming, and Potter 2013).

The State’s Role in Development

These PFM frameworks are cognizant of the role of the state in development through public spending. A key difference between today’s Organisation for Economic Co-operation and Development (OECD) countries and developing countries is the size of the public sector in the overall economy, where tax and spending ratios are commonly in the range of 30 to 50 percent of gross domestic product (GDP). These ratios grew over time as OECD governments spent progressively more on health, education, social protection, and infrastructure. At the same time, these countries developed more sophisticated PFM systems, which was viewed as necessary to provide the required accountability mechanisms to raise taxes and debt to finance higher rates of expenditure. Later developing and less advanced economies have followed a similar trend, though without reaching similar levels of expenditure as a share of GDP.

Furthermore, successive global drives to increase the welfare of the citizens in developing countries have also included strengthening public expenditure systems and resource mobilization. For example, during the Millennium Development Goals (MDGs) era from 2000 to 2015 donors aimed to support more capable states by providing budget support to developing countries using country systems. Under the Sustainable Development Goals (SDGs), the international community is focusing significant attention on supporting developing countries to increase their budgets through domestic resource mobilization and access to private finance.

PFM as a Means to Achieving Other Desirable Outputs and Outcomes

To turn these laudable goals into a reality there has been increasing recognition of the ‘instrumental’ role PFM plays in delivering services on which human and economic development rely. 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 2012, 51). This link between inputs and service delivery outputs and outcomes led to the use of public expenditure tracking surveys (PETSs) that trace the actual flow of public funds in a program or a sector and establish the extent to which public funds and other resources reach service providers. Although different public services will require a different mix of these inputs, regular payment of staff salaries is likely to be critical to the delivery of all public services (Welham, Krause, and Hedger 2013; Welham et al. 2017).

PFM and Development

However, both during the MDG era and now in the SDG era, donors seeking to promote state-led development through country PFM systems face a dilemma: many of the countries that they are seeking to support have extremely weak PFM systems. Indeed, early PETSs revealed large amounts of leakage in the flow of funds. This leakage exposes donor support to fiduciary risk or the more general risk that their support will have little impact. It has also led to an increase in technical support to improve PFM systems through reforms.
Conditionality has aimed to strengthen the PFM system in aid-recipient countries to help to ensure that aid is used effectively for the purposes intended (DFID 2009). This conditionality was particularly important with the shift toward budget support as an aid modality during the MDG era, with funds channeled directly to a recipient government’s treasury account and thereafter executed using the country’s own allocation, procurement, and accounting systems. Similarly, debt relief programs launched in the late 1990s and 2000s have been used as leverage to move the indebted country into a new mode of operations to ensure that resources freed up through debt relief are used to reduce poverty or increase growth. To meet aid conditionalities, countries have had to develop action plans to strengthen systems for public expenditure management.

The Emergence of Diagnostic Tools for Assessing PFM Systems

However, during the MDG era, each donor was initially using its own diagnostic tool to assess whether it should provide budget support through country systems, creating a massive compliance burden for recipient countries. The Paris Declaration on Aid Effectiveness (2005) committed donors to implement harmonized diagnostic reviews and performance assessment frameworks in public financial management.

The PEFA framework emerged as the instrument with which to harmonize these various diagnostic tools and, as a result, has become the most widely used assessment of PFM performance in low- and middle-income countries.

The PEFA framework was introduced with three goals in mind: (a) to strengthen the ability of governments to assess systems of public expenditure, procurement, and fiduciary management and contribute to a government-led reform agenda; (b) to support the development and monitoring of reform and capacity development programs and facilitate a coordinated program of support; and (c) to contribute to the pool of information on PFM.1

Since its launch in 2005, nearly 600 formal assessments (national and subnational) in 150 countries and territories have been undertaken and verified by the PEFA Secretariat. Today, most development partners use the PEFA framework as the basis for their diagnostics of PFM systems and assessment of associated fiduciary risks, especially to determine when to use country systems for individual operations. It has become the go-to measure of public financial management.

Due to the international recognition of PEFA, there has also been a proliferation of other institutional diagnostics that largely replicate the approach and methodology of the PEFA framework. Most of these diagnostics focus on specific elements of the PFM system. Examples include the World Bank’s Debt Management Performance Assessment (DeMPA) as well as the International Monetary Fund’s Tax Administration Diagnostic Assessment Tool (TADAT) and Public Investment Management Assessment (PIMA).

Donor Spending for Strengthening PFM Systems

Donors provide considerable financial support to PFM. Data from the OECD’s Development Assistance Committee database shows a dramatic increase in disbursed funds for activities related to public sector financial management, which trebled from US$406 million in 2002 to US$1.3 billion in 2016 after peaking at roughly US$1.8 billion in 2011 (figure 1.2). This surge in financing has naturally led to questions about whether this spending is achieving the desired results.

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Research Contribution to Discussions on PFM Performance and Issues in PFM Reform

While there is general recognition that PFM is important for development, there is limited empirical evidence on what determines “better” PFM performance and the outcomes associated with a “good” PFM system. This report seeks to bridge some of this gap between theory and practice using data on PFM performance from PEFA assessments.

In the next chapter, we undertake a closer examination of the key debates on what constitutes a good PFM system by providing an overview of the PEFA framework and the data set that is generated through PEFA assessments. This overview includes an analysis of the pros and cons of undertaking quantitative analysis using PEFA and similar governance indicators. Our aim is to address specific criticisms of the PEFA framework and similar diagnostic tools and to provide a guide to interpreting the analysis in the remaining chapters, including understanding its inherent strengths and weaknesses.

Chapters 3 to 6 examine the relationship between PFM performance and other indicators of governance. Across all four chapters, we try to tease out which parts of the PFM system matter more for different questions and attempt to quantify the impact of PFM reforms where relevant, albeit with important caveats.

In chapter 3 we investigate what shapes PFM systems in developing contexts by examining the relationship between political institutions and the quality of PFM systems. This chapter builds on the existing theoretical and empirical literature by refining and nuancing previous hypotheses on this relationship, retesting hypotheses using a larger sample, and testing new hypotheses. Much of this theoretical and empirical literature is based on observations for higher-income countries. We find little evidence that these relationships hold in low- and middle-income countries and note some counterintuitive relationships. Although we do find some evidence that having multiple political parties controlling the legislature is associated with better PFM performance
more generally, our findings point to the need for further refinement and testing of the theories on the relationship between political institutions and PFM in low- and middle-income countries.

Chapter 4 assesses the outcomes of PFM systems, distinguishing between fragile and nonfragile states. Specifically, we explore whether the credibility of the budget and fiscal outcomes improve with better PFM performance using various definitions of fragility. Our findings are mixed. We find that better PFM performance is associated with more reliable budgets in terms of the composition of expenditures in fragile states, but not with aggregate budget credibility. Moreover, in contrast to existing studies, we find no evidence that PFM quality matters for deficit and debt ratios, irrespective of whether a country is fragile or not.

In chapter 5, we turn our attention to the relationship between corruption and PFM performance. Our analysis is limited by the constraint that there is no cross-country measure of actual corruption. We therefore use corruption perception indexes as a proxy, with the potential measurement error that comes with using such a blunt instrument. Nevertheless, we find strong evidence of a relationship between better PFM performance and better perceptions of corruption. We also find that PFM reforms associated with better controls have a stronger relationship with better perceptions of corruption than PFM reforms associated with more transparency. However, the magnitude of the relationship is underwhelming when compared with the magnitude of the relationship between economic growth and perceptions of corruption. This finding is in line with the findings of other studies. Our findings suggest that PFM reform may be part of an effective anti-corruption campaign or that contexts where the perceptions of corruption are improving are more amenable to PFM reform. However, much scope remains for further research in this area to define individual PFM measures more tightly with more relevant measures of corruption.

We follow this advice in chapter 6 by looking at a more tightly defined relationship between domestic resource mobilization and revenue administration. We focus on the impact on tax performance of the credible use of penalties for noncompliance. This tool has become somewhat neglected from a research perspective, as more modern revenue administrations have shifted their focus toward voluntary compliance and taxpayer services. Our analysis shows that countries that credibly enforce penalties for noncompliance collect significantly more taxes on average. Due to the potential for measurement, further in-country research on the dynamics of penalties for noncompliance is warranted. This would allow for analysis of the individual responses of taxpayers to the use of penalties for noncompliance.