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**Working Party on Aid Effectiveness and Donor Practices**

**DRAFT GOOD PRACTICE NOTE ON CAPACITY DEVELOPMENT IN  
PUBLIC FINANCIAL MANAGEMENT**

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*This paper is presented for DISCUSSION at the next meeting of the Joint-Venture on Public Financial Management. It was elaborated by GTZ and the World Bank.*

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## GOOD PRACTICE NOTE

### ON CAPACITY DEVELOPMENT IN PUBLIC FINANCIAL MANAGEMENT

#### I. KEY ISSUES

1. Good financial governance is crucial to countries making progress in reducing poverty. Good financial governance encompasses an effective, efficient, transparent, and rules-based PFM system. The connection between the quality of PFM systems and poverty reduction was given added attention with the introduction several years ago of the HIPC debt relief initiative. Most of the Poverty Reduction Strategy Papers (PRSPs) that partner countries have developed recognize explicitly in their text that poverty reduction is not merely a question of spending more, but also of how to use resources. Progress toward achieving the Millennium Development Goals (MDGs) has given additional urgency to improving PFM as an enabling condition for poverty reduction. In essence partner countries increasingly recognize that problems in sectors such as health, education, and agricultural can have common origins in weak PFM. Furthermore, making aid flows more predictable, improving procurement systems and granting budget support also requires adequate capacities in PFM. While capacity development is central for all modes of delivery of development aid, the growing interest among donors granting loans to move to budget support as an alternative to project-based lending has fueled increased concerns over capacity development in PFM.<sup>1</sup>

2. UNDP (2002) defines *capacities* as comprising “the ability of people, institutions and societies to perform functions, solve problems, and set and achieve objectives”. *Capacity development* denotes the *process* by which partner countries are enabled to make better use of existing capacities and to further develop capacities at three levels: (i) the individual level, (ii) the level of organizations and (iii) the institutional and political level. According to a definition by Norad/Sida<sup>2</sup>, *capacity development in PFM* aims at developing the rules and procedures in PFM, organizing the work and provide resources (physical, human, financial) in a way that facilitates their efficient implementation, and equips people in the organizations with competencies to operate efficiently in accordance with them. The overall aim is to make PFM an efficient tool for implementing policies and producing services for the benefit of the people as well as providing an accountability mechanism for controlling government and the public service.

3. For the purposes of this paper PFM is assumed to include instruments and measures in budget formulation, revenue administration, commitment and payment of expenditures, internal control and audit, debt management, accounting and reporting, external audit, legislative oversight, and fiscal

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<sup>1</sup> Project-based lending, including segregated project management units, has given some assurance that funds would be used properly, but the parallel systems have only helped to undermine capacity development. Resources that could have gone directly into PFM enhancements instead went into setting up external structures. Yet, for budget support to gain wider usage, donors must still find ways to respond to fiduciary concerns of their national stakeholders. Improvements in the capacity of PFM systems are one of the ways that partner countries are looking to address fiduciary concerns.

<sup>2</sup> Norad/Sida 2002: Best Practice in Capacity Building in Public Finance Management in Africa, p. 9.

decentralization.<sup>3</sup> PFM is also concerned with certain cross-cutting themes such as budget comprehensiveness, transparency, fiscal discipline, and efficient resource allocation to priority needs; the “PFM Performance Measurement Framework”, for instance, proposed by the joint World Bank-IMF-PEFA Working Group, attempts to cut across national and cultural distinctions to provide a common reference guide as to what represents good practice in each area of PFM.<sup>4</sup> While most donors have focused in the past decade on “what” PFM reforms should look like, e.g., enhanced practices and procedures of organizations, only few have already reflected on “how” capacity development in PFM takes place. Going forward, much more attention must be given to the “process” of developing capacity in PFM. The ability to assess capacity in PFM has been well-honed, whereas experiences in general are still relatively limited on “how” capacity development is best nurtured. A new paradigm is needed – one that is less focused on imposing a particular PFM blue-print and instead one that facilitates an environment in which PFM capacities build progressively.

4. Apart from the technical aspects of capacity development in PFM (which are at the core of this note) it also has a political high-level dimension. The political backing of PFM reforms is imperative to achieve substantial changes on the recipient side. On the donor side, increasing emphases are on the adequate mode of delivery for partner countries (including stand-alone bilateral Technical Co-operation, Technical Assistance within pooling arrangements, Sector Wide Approaches and budget support) and on its respective relation towards PFM reform activities, especially regarding the matter of sequencing. For instance, while some donors argue, that budget support has beneficial effects by initiating PFM reforms within partner countries, others stress that establishing a reliable PFM system in the framework of Technical Co-operation first is a pre-requisite for providing efficient budget support. Donors therefore need to focus on both developmental and fiduciary aspects.

5. The high technical complexity of capacity development in PFM as well as its political dimension stress the need for more and better donor harmonization.

## II. PURPOSE

6. Based on existing country experiences the purpose of this paper is to highlight some of the good practices on *how* capacity development in the realm of PFM has been effectively supported by donors. The good practice examples given are not intended to be exhaustive or prescriptive, but rather to illustrate how effective support of capacity development is beginning to take shape in a few countries. The paper seeks to provide guidance to donor organizations for improving the effectiveness of aid delivery aimed at capacity development in PFM.<sup>5</sup> It draws upon common principles that can/should be applied to PFM capacity development, though the application of them will vary across countries.

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<sup>3</sup> Though also being part of PFM, procurement issues are not covered in detail within this note; another OECD initiative explicitly addresses this topic. See Joint OECD – World Bank Round Table on Strengthening Procurement Capacities Development: Good Practice Paper on Procurement Capacity Development, 2004 (forthcoming).

<sup>4</sup> The “PFM Performance Measurement Framework” is currently structured around 28 dimensions of PFM and outlines four performance levels for each. See Room Document 2 of the Third Meeting of OECD DAC Working Party On Aid Effectiveness and Donor Practices, 8-9 July 2004: PFM Performance Measurement Framework.

<sup>5</sup> The “Strengthened Approach” to PFM that has been developed by the PEFA partners is also in line with this note. The Strengthened Approach represents a greater reorientation of donor assistance from diagnostics to capacity building in support of a country’s own strategy and action plan for PFM. The approach also proposes good practices that donors should incorporate to meet their fiduciary obligations while reducing the transaction costs to partner governments.

### III. GUIDING PRINCIPLES

7. An overarching principle that must guide our work in the future is that capacity development is not an activity of donors but rather a task of partner governments. In other words, capacity development is primarily endogenous to a country, based on voluntary action and motivation. Exogenous aid initiatives can support capacity development, but they are not a substitute for it. Capacity development efforts should therefore be rooted in the partner country's own goals and strategies. Furthermore, the motivation for capacity development should transcend which mode of delivery is to be provided.

8. Though some efforts to support capacity development over the past decade have fallen short of expectations, important principles have emerged that can guide work going forward:

**A. Supporting country leadership and ownership should be central to donor approaches.**

Capacity development is most likely to succeed when countries view it in their own self-interest and are committed to taking the actions necessary to implement it. For many countries elements of a PFM capacity development strategy already exist in some form. The role of donors therefore is to *facilitate* rather than direct the process of turning broad goals and strategies into an actionable plan. Donors have little ability to create incentive for capacity development where it does not already exist.

Country ownership implies an engagement throughout the entire value chain of activity problem definition, diagnostic analysis, design of the action plan and proposed interventions, and of course, implementation. Country leadership may mean that some of the specific interests or requirements that donors have cannot be pursued immediately. However, the ability of donors to facilitate country leadership through out each phase of capacity development is essential to achieving genuine impact.

**B. Capacity development design and sequencing should fit specific country circumstances, rather than reflect standard or imported solutions.**

Effective capacity development starts with a premise of building upon what already exists, rather than transplanting entirely new systems. Capacity development in PFM should make use of local knowledge and build upon existing values where possible. The timing and scope of interventions are designed to be consistent with the country's capacity – be it political, social, or managerial – to implement change. All too often well-meaning capacity development programs have led to over-stretching of key government officials and a dispersion of effort that minimizes results. Well-sequenced capacity development also takes into account the building blocks of a PFM system that must be in place for subsequent reforms to succeed. It balances the need to generate short-term “wins” with a longer-term view of how deep and lasting change occurs.

**C. Institutional, organizational and individual issues including managerial, and technical aspects should all be taken into account in program design and implementation.**

Capacity development must be viewed from a holistic or systemic perspective, and not merely as a transfer e.g. of skills. Though new equipment, training programs, and updated procedures all play a role, design of effective capacity development takes into account the institutional and organizational context in which change must occur. Technical solutions should be also supplemented by review of the broader social/political context, incentives of various stakeholders, the impact of human resource policies and practices, as well as the culture of the public service as a whole. In some cases, individuals may already have the necessary skills and experience, but the environment in which they work inhibits or the organizational may inhibit performance. In promoting change, and in order to achieve sustainable results instead of only temporary islands of excellence, it is important to understand how these various system levels interact. Donors must increasingly consider change management issues, and how the *process* of developing capacity can be managed effectively by the organization. Indeed, capacity developing requires having capacity.

**D. Donor support should be provided in a coherent, coordinated, and programmatic manner.** One of the primary responsibilities of donors should be to minimize the transaction costs to Government of working with multiple donors. Therefore, wherever possible donors should strive to harmonize procedures and monitoring mechanisms. As to the content of the capacity development, the government's own action plan should be the focal point for determining support. Though donors may come with different areas of expertise within the overall program, their support should be complementary rather than competitive or duplicative. Support should be phased over a multi-year horizon in order to take into account the long-term nature of capacity development. Likewise, interventions should be programmed in a way that reflect how they best fit together for the country's own development objectives.

#### IV. GOOD PRACTICES

##### A. *Facilitating country leadership and ownership*

9. Country leadership and ownership are critical to capacity development if it is to succeed. Often capacity development has been supply-driven (by donor needs) rather than demand-led from Government's own agenda. Regardless of the level of funding, commitment, or technical expertise of the donor agency, without national champions for reform, investments in capacity development have rarely proved significant or sustainable. Tying capacity development to loan conditionalities has also had a doubtful impact in generating true country ownership. In contrast, donor agencies must transform their role from one of leading capacity development to that of facilitating. By allowing the country to take a lead in the identification and design of capacity development efforts in PFM, the donor agency benefits from important insights into where critical entry points are and in how to assure that the recommendations are appropriate for the country context. Because capacity development in PFM can entail major changes in organizational behavior and incentive structures, the design of capacity development programs must benefit from those who understand these factors well. Despite obvious benefits from encouraging country leadership and ownership, it has been difficult to achieve at times. Incentives within donor organizations themselves sometimes mitigate against the slower, more facilitative role that is needed to encourage country leadership. Pressures e.g. to conduct diagnostic analysis and/or to show results on the ground can lead donor agencies to proceed ahead with activities, even while government may be questioning the utility or timing of the mission. Similarly, the objectives and goals of donors and partner countries are sometimes divergent, where the areas which are viewed as priority among the former are not the same with the later. Or donor objectives may be far more ambitious. There are other situations in which doubts prevail among donors about government's ability, for example, to diagnose the areas of weakness and to prescribe appropriate remedies.

#### **Box 1. JICA's support of ownership in the Vietnamese Tax Reform Process**

Since the mid-1990s the Japan International Cooperation Agency (JICA) has been providing technical support for Vietnam's tax reform. The responsibility of the partner countries' institutions was to be strengthened as much as possible. The following measures undertaken to ensure ownership are particularly worth mentioning:

- Starting from a comprehensive joint study on economic development policies, the area of co-operation was gradually narrowed down to the introduction of Personal Income Tax (PIT) following the priority given by the Vietnamese side.
- Japanese experts presented alternative models of PIT from other countries, i.e. China and Japan, instead of presenting a blue-print. So the Vietnamese partners could make final decisions among various options, taking furthermore local conditions into account.
- To improve the Vietnamese colleagues' practical expertise as a pre-requisite of a self-dependent reform process in tax policy/administration, the twinning of the Japanese and the Vietnamese Ministry of Finance has been significantly strengthened.

Source : JICA, Japan

10. Though the picture is often mixed, some significant and telling examples emerge about how country leadership and ownership have been achieved:

- ***Taking a long-term view of the engagement and building a common language for dialogue.*** The complexity of capacity development in PFM in a specific country context, implementing new structures and procedures etc. require a long-term perspective in planning and executing activities of capacity development in PFM. Possible backlash effects needs to be taken into account.<sup>6</sup> Getting government to embark upon a program of capacity development may often need to start with simply building a common understanding of the current problems and challenges they face. In Andhra Pradesh, financial control and financial accountability issues were appropriate concerns of donors, but they were not the initial priority of the Government. As a result, donors adopted a flexible approach to priority setting and assisted GoAP first to improve the predictability of budget releases to spending ministries. After this was accomplished, GoAP opened the door to discussions about financial control issues. The donors' sustained dialogue and willingness to adapt to country circumstances helped the Government develop home-grown reforms in financial accountability.
- ***Using joint diagnostics to facilitate ownership.*** In Tanzania, Government and donors have redefined the traditional Public Expenditure Review (PER) work from a study that primarily fulfills fiduciary requirements to one that is part of the Government's work plan and helps to feed in to the annual budgetary decision-making cycle. Though the PER still provides key information to donors working in critical sectors, the process is primarily organized behind government's own budget process and feeds into it. Donors work in a supportive role under government's leadership even as it conducts further analytical work. In Senegal a different approach was taken, but the process for conducting PFM diagnostics included an extensive government counterpart team. A joint government-donor workshop on the findings and recommendations was used by government to formulate its own action plan for capacity development.
- ***Building upon external incentives for reform.*** In some countries, external influences or political crisis have helped make capacity development a priority for government. For example, in both Columbia and Guatemala – two countries which successfully implemented new information systems for financial management – public pressure to address corruption and improve transparency in public finances made reforms politically important. In Benin, however, government's participation in regional bodies such as the West African Economic and Monetary Union (WAEMU) gave additional incentive for embarking upon PFM capacity development because of the desire to meet the new standards (e.g., in budget nomenclature) that were being established for member countries. At times, capacity development must be opportunistic.
- ***Stepping back to create space for government to lead.*** Where government does not appear to be leading the process, it presents particular challenges for donors. Where adequate information is available about the nature of the problems faced, donors may need to give government time to respond. In Madagascar a substantial body of analytical work had already been conducted by various donors on the problems in PFM, little of which had been incorporated into the Government's strategy. When a new government was elected in 2002 committed to PFM reforms, donors made the choice to step back and allow the Government adequate time to develop its own reform agenda and action plan. Once the 2003 Action Plan was unveiled, donors

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<sup>6</sup> Depending on the objectives and on the specific country circumstances achieving sustainability of PFM reforms requires decades rather than years. According to Norad/Sida a period of 15 to 25 years might be appropriate. See Norad/Sida 2002, p. 26f.

accepted it as the focus for government-donor dialogue about capacity development and how donors could assist.

- ***Relying upon leadership of the Ministry of Finance (MoF) and beyond.*** MoF leadership is critical for implementing capacity development concerning PFM. In particular, the top management of the MoF should actively participate in the reform process. Nevertheless, reforms can be easily derailed, if even the operational staff does not understand and support the change. This requires the design of actions aimed at promoting change and communicating the changes to and through middle management, in order to gain acceptance and active cooperation from the staff. That implies creating a “culture of ownership” regarding the reform process. Therefore, it is desirable at each stage of the process to highlight information on progress, to encourage and to respect feedback. The broader and more far-reaching is the capacity development, the more likely it is that champions are needed beyond a single ministry. For example, in Guatemala leadership of the reform stretched to the Presidential level as it became clear that improvements in social outcomes could only be achieved with an improvement in the underlying PFM system. The political context at the time – ending of a civil war and negotiations with guerilla groups – made progress imperative, and extensive analytical work had helped establish a link between the ineffectiveness of the health sector and weaknesses in the PFM system. The reforms included implementation of a new computerized information system and a significant decentralization of financial responsibility to newly established accounting units in line ministries. Though seemingly limited in scope, it was clear that the new financial management system, accompanying regulations, and institutional structures would have wide-ranging ramifications. Significant downsizing occurred in the reorganization of functions, and new responsibilities were established. Reforms of the revenue authority in Rwanda also benefited from leadership from the President.

#### **Box 2. Creating “agents of change”: France’s support to Lebanon**

Since 1993 the Lebanese Ministry of Finance (MoF) has embarked on a number of initiatives to help implement the government strategy to modernize the economy and to place it on a sustainable growth path. The success of these reforms depends on training programs to instill more professional working practices, and induct a new generation of highly skilled staff.

The Lebanese MoF established the Institute of Finance (IoF) in 1996 supported, inter alia, by Adetef, in order to achieve benefits from specialization by a center of training and communication. As an “Agent of Change” the IoF is designed and implemented as the first-ever in-house assessment of staffing of the MoF with an access to a database of all employees.

One of IoF’s major tasks was to help improving internal communication at the MoF thus ensuring that senior management in the administration had a good understanding of the aims and benefits of the new systems that are being introduced, and identified with them. By engaging current and new staff into the reform process and encouraging them, through dialogue and through learning and exposure, to adopt modern work methods, procedures, and information tools, the IoF has helped the MoF to ensure ownership of the reform efforts undertaken. This has also led to creating, within the MoF’s various directorates, an enabling environment for staff to continuously develop their knowledge, to upgrade their skills, and to provide orientation and coaching and clear career paths to the new generation of young staff.

In the last two years, the IoF has become in addition a resource center for other Lebanese public institutions and has been instrumental in providing training to staff of the MoF of various countries of the Middle East and Arab region. It is today one of the leading learning public sector institutions in Lebanon and the Arab region. The IoF has been successful in building partnership schemes with specialized local, regional and international institutions, too. Consequently, it was able to facilitate the participation of Lebanese MoF staff to training and learning events outside Lebanon.

Source : Adetef, France



11. Institutions and organizations that are outside the Executive can also be important to building commitment and ownership of capacity development. In Bangladesh, for example, not only was the Minister of Finance firmly behind capacity development in PFM, but strong support came from the Comptroller and Auditor General (C&AG). The support of the C&AG has been important because much of the capacity development efforts have focused on accounting practices and procedures, including a new chart of accounts, updated accounting manuals, and the creation of new management accounting units within the largest spending ministries/divisions. Moreover, in situations where demand from the Executive may be weak, donors may need to conduct outreaches to the legislative body, the external audit organization, or civil society in general. By informing the public and the legislature about PFM issues, an initial constituency for PFM can be nurtured and that will eventually influence the Executive.

12. Finally, it is helpful to clearly define responsibilities for managing the complex reform process by setting up a core reform unit that is responsible for the overall reform process. Thus, with the proper incentive structure in place an “agent of change” can be created, whose members’ own interest is the progress of the reform process.

- ***Building interest in line ministries.*** While support for capacity development tends to be cultivated at senior levels of government and within MoF, ownership of capacity development by line ministry staff has also been an important factor of success in some cases. For example, with the implementation of program budgeting in Benin, support from key line ministries was vital to its acceptance. In Guatemala, development of the Financial Management Information System (FMIS) generated support within line ministries to see the changes implemented. Training and outreach extended to a wide range of users, which helped build interest in the new system even down to the technical staff. In Bangladesh, likewise, there were deliberate efforts taken by the project team to create a “bottom- up” interest in capacity development and the PFM reforms underway. A measure of public relations was done to publicize success stories and broaden support. Formal and informal teams, as well as functional and cross-functional teams, were promoted and nurtured to facilitate the exchange of ideas, share experience, and identify common ground for cooperation.

13. In general, one can expect that the stronger and more widespread the level of political commitment, the more complex the capacity development that can be sought. In environments where country ownership and political commitment is weak or narrowly focused, capacity development would more likely focus on routine or technical issues, such as accounting procedures. In contrast, areas that would involve major shifts in institutional responsibility should be accompanied by strong political commitment, bureaucratic willingness, and some degree of capacity. In Bangladesh, a strategic decision was made to start off with the more technical types of issues (e.g., budget classification, accounting practices, etc.) before endeavoring to change areas that would create strong bureaucratic resistance.

#### ***B. Fitting strategies to country circumstances***

14. Capacity development efforts must be tailored to country circumstances if they are to succeed. Technical solutions cannot necessarily be transposed from one country to another. For instance, reforms in the field of fiscal decentralization has to take into account the existing structures and interlinkages of the political layers (central, regional, local etc.) in a country. Likewise, the sequencing of reforms in PFM has to take into account country specific factors, including the political climate for reform, institutional incentives, and the managerial capacity to lead the process. In addition, some elements of the PFM system may be more critical to address as a foundation for going forward in other areas.

15. ***Being responsive to Government’s most pressing need.*** The entry point for capacity development will vary by country; there are no fixed parameters on what aspect of PFM should be

addressed first. In some countries such as Hungary, building a reliable treasury system was the first priority in its post-communist transition. In Sierra Leone getting the payroll system working was a priority after the end of civil conflict. Other countries may start with revisions to the legal framework governing PFM. Though diagnostic work may show donors areas of the PFM system that appear to be weakest, they give little indication of what are the priorities of government. The areas that appear weakest may not necessarily be the most critical to PFM improvement or the most doable given the current institutional climate.

16. **Supporting Government to set clear objectives and advance incrementally.** In a complex system like PFM it is not possible to identify all relevant reform variables ex ante, which can be, furthermore, subject to unpredictable changes. Hence, it is necessary to review continuously to make sure that reform activities are on track and to re-engineer if necessary. This requires a clear set of objectives, priorities and clearly delineated activities, outputs and success measures, that also the donor side should bear in mind. A formulated action plan of the partner should be clear in its objectives, but flexible in its approach for being able to respond to unforeseen events. “Trial and error” is the underlying principle to achieve these objectives. This implies that the reform process is to be shaped by just small reform phases that allow for fast re-orientation when necessary. Furthermore, during the reform process progress needs to be continuously monitored and reviewed. Monitoring and evaluation should be impact-oriented and cost effective. A focus on improvement of routine processes may be advantageous, because it needs less managerial capacity and is easy to monitor.

17. **Focusing on a specific PFM outcome, rather than a department or function.** Country officials also make judgments about what the institutional incentives are, and must balance long-term strategic objectives with the need to show short-term gains. In Sierra Leone, not being able to execute the payroll represented a substantial risk and one which government felt had to be addressed as a priority. But this also became way to focus other capacity development elements that supported effective payroll management, including strengthening the internal audit of payroll. Thus, capacity development initiatives were focused on specific outcomes, which in turn guided the design of training and other capacity development.

18. **Getting the basics right.** The type of capacity development should be appropriate for the state of a country’s PFM system. Procedures and practices that are used elsewhere may not necessarily be appropriate in the partner country, especially if certain preconditions do not exist. For example, in a system where annual budgets have little meaning because of large reallocations during the year, introducing a medium term expenditure framework (MTEF) may be premature. Likewise, there are limits in how far one can go in strengthening external audit if the Ministry of Finance is unable to produce timely and credible financial statements. In short, governments and donors need to assure that the basic fundamentals are being addressed if they impact other parts of the PFM system. Though it is still early, an approach being tested in Cambodia structures dialogue with government around four progressive “platforms” of PFM performance. Only after the first PFM platform is achieved, do donors and government consider the next platform. The first platform focuses on budget predictability and is planned with a two-year time horizon. Having agreed upon the goal, donors can be more receptive to various strategies government may propose to achieve it and avoid pressing for other objectives.

19. **Extracting key concepts in lieu of replication.** Effective capacity attempts to build upon what already is in place, rather than seek wholesale replacement of existing systems. Building on existing capacities simple-to-handle instruments and procedures can be expected to be more easily accomplished than sophisticated ones. Some advanced concepts can be introduced gradually, but only by extracting the elements that are most practical for the country. Program budgeting, for example, may have some useful concepts that can be applied to a developing country PFM system. But the focus should be on slowly introducing the basic principles without trying to replicate a system found in more industrialized countries.

### C. *Integration of institutional, managerial, and technical aspects*

20. Donor experiences show that effective capacity development must include consideration of change management themes as well. How government will manage the process of building capacity can be as important as the PFM proposals themselves. Managers are often busy and stretched thin with day to day responsibilities, while many capacity developments efforts require thinking about activities that will have only a longer term impact. Use of external technical assistance may fill gaps, but it is not a solution by itself. Nor can training of individual staff be ignored.

#### **Box 3. Typical challenges linking PFM sub-systems in partner countries**

The budgetary process should be unified - with the MoF sufficiently empowered. In particular, the budget department of the MoF should be fully responsible for the preparation of the budget. This includes the capital investment budget and the review of sectoral budget submissions.

- A unit for macroeconomic and fiscal forecasting should be established in the MoF.
- The distribution of responsibilities between the treasury department and the budget department are to be clarified and their coordination should enhance the preparation of the budget implementation and cash plans.
- Debt management departments should be unified. Linkages between debt management, preparing budget implementation and cash plans are required.
- Coordination between tax administration and departments responsible for preparing tax forecasts, and continuously updating them, might be reinforced.
- Interministerial cooperation needs strengthening at the political and operational level, e.g. MoF – Ministry of Economy – National Statistics Office.
- Parallel reforms at the central and sector level are required, e.g. improving investment budgeting depends on the effectiveness of procedures to screen and select projects within the line ministries; dealing with the problem of generating arrears requires an efficient internal control within line ministries. Conflicts between the central and the sector level should be avoided.
- Attention should be given to the linkage between the central and subnational layers. Devolution requires e.g. improved circulation of information and increased awareness of fiscal problems within subnational authorities.

Source : OECD 2001: Managing Public Expenditure

21. PFM capacity development must also be thought of systemically or holistically. Changes in one area are likely to be influenced by changes or the lack thereof in other areas. No component of the PFM system stands in isolation; nor can the technical aspects of PFM in individual, institutional and organizational terms be separated from their managerial and even wider cultural respectively societal context. At times, the legal framework, the institutional incentives, or the human resource policies in place can all have an impact on whether capacity development efforts succeed. Moreover, civil servants in an institution may already have the needed technical capacity, but are hampered by the institutional setting and incentive structure in which they must work. Though they may not all be addressed at once, they should nevertheless be factored into the design of capacity development programs.

22. The functioning of a PFM system very much depends on all these elements and their interplay. Hence, effectively developing capacities in PFM calls for a broad understanding of PFM systems including all relevant PFM-areas and capacity levels as well as their reasoned interlinkages. Both managerial and technical aspects have to go hand in hand. The picture becomes more complex, since PFM systems are integral parts of the overall public sector. The quality of the PFM systems depends on the shape of the overall public sector. A general lack of transparency within the overall public sector, for instance, negatively affects PFM.

**Box 4. The Revenue Authority as a key organization: DFID's support of Rwanda**

DFID's support to establish the semi-autonomous Rwanda Revenue Authority (RRA) in 1997 played a strategic role in Government's broader political vision contributing to develop a culture of participation and citizenship within the norms and practices of democratic governance.

Once revenue collection was not taken seriously, neither by Government nor by the public, there was a tremendous scepticism about the intentions of setting up the RRA at the beginning. Thus, DFID was seen the need to transform the image and standing of the revenue services and to establish a new relationship with its stakeholders (GoR, taxpayers, and organisational partners) based on trust and co-operation.

Strengthening the organizational structures and processes of RRA has been complemented by efforts to manage the organisation's external environment. This involved public relations and awareness building as well as an orientation of business processes towards tailor-made services to customer groups and measures to increase transparency and accountability to end users. Furthermore, the establishment of co-operative relationships of RRA with its stakeholders has given access to needed resources (such as technology, information, support, etc.), and has been important in terms of extending the organisation's outreach and effectiveness. In order to effectively perform the RRA has gone so far as to invest in the development of partner capacities, i.e. helping to organize the nascent tax consultancy profession and to develop the revenue collection capability of local governments. Thereby, gaining legitimacy from its partners and from the citizenship as a whole has been a key driver for success of RRA.

Source : DFID, UK

23. Furthermore, PFM systems are embedded in a society as a whole. In order to avoid creating islands of success in oceans of failure, an effective PFM system requires a civil society of constituents willing to bear e.g. their tax burden and to make use of their rights. Good financial governance is, therefore, closely related to overall existing key issues like respect for human and civil rights and a general bias towards corruption, bribery, and tax evasion. Thus, successfully supporting reform activities requires an understanding of the country context, too. On the one hand normative rules defining duties (e.g. on which incomes to report) of the constituents need to be followed. On the other hand positive rights granted have to be utilized (e.g. making use of tax allowances or complaining against improper tax assessment). Thus, the constituency has to be informed about changes that have taken place. Marketing is especially important in terms of gaining the support of the public at large and in creating legitimacy. Besides increasing the efficacy of reforms this will also have an impact on ownership.

24. **Integrating institutional and organizational issues.** Some forms of PFM capacity development risk confronting substantial institutional resistance. If donors wish to proceed, such challenges need to be addressed in the design of capacity development. In the case of Turkey, the PER exercise was transformed into something that went beyond the typical examination of strengths and weaknesses of PFM. Instead, the process of carrying out the PER became one of capacity development. The PER was used as vehicle for bringing together different institutional interests around the table to discuss critical PFM issues. Consensus within government on a plan of action came about through the PER exercise, and major legal reforms were subsequently implemented as a result.

25. Implementation of FMISs is another area that is heavy on technical issues, but that will fail if broader institutional and managerial themes are not well integrated. FMIS projects potentially involve major shifts in responsibility from MoF to line ministries, huge changes in the incentives and power relations within ministries, and implications for recruitment and retention. Guatemala is one of the success stories in FMIS implementation, and change management issues were squarely part of the project design. The team considered the implications for organizational structures, job descriptions, and how to align staffing needs with the new informational outputs and decision-making procedures. MoF was reorganized to be consistent with its new role, and new accounting units were created within line ministries which happened to have a lesser stake in the old legacy systems that were being replaced. A wide range of users were also trained in financial management, which helped improve acceptance and understanding of the new system.

**Box 5. JBIC's support for a systemic approach: Aid and Debt Management in Ghana**

Development funds are critical for Ghana's solvency. When the Comprehensive Financial Management Reform Program 2002-2007 was committed by the GoG based upon Ghana Poverty Reduction Strategy, JBIC (Japan Bank for International Cooperation) decided to extend Technical Assistance for Aid and Debt Management. JBIC's support includes individual, institutional, and organizational measures at the same time according to a systemic understanding:

- Training for Aid and Debt Management Unit (ADMU) officers for proper understanding of debt management system.
- Establishing administrative rules of procedures in order to enable ADMU collecting necessary aid and debt related information from relevant ministries at proper time.
- Fostering systems for a better understanding of concerned organizations.

Three times JBIC organized participatory workshops. In these workshops, the Ghana counterpart personnel were enabled to review on their own in. what are the problems in this area, ii. why those problems took place, iii. how they can be resolved, and iv. what actions should be taken. The results of a series of discussions on these issues were reflected in the project design. Thereby ownership could be strengthened. This strongly enhanced motivation as well as working skills to the staff of the counterpart.

Source : JBIC, Japan

26. **Using training strategically to support institutional and organizational changes.** Though the focus is on improving organizational performance, training of individuals remains an important element of capacity development. In other words, changes in procedures and policies often need to be accompanied by extensive on the job training to assure that the new concepts can be implemented. In Guatemala and Bangladesh thousands of individuals were given training in PFM to facilitate the implementation of the new procedures. In Benin, workshops on program budgeting began well before a formal project was established so that key ministry officials could be acquainted with the concepts and make decisions on its implementation. During the project in Benin, there was extensive hands-on training, as donor experts would review draft program budgets and provide specific guidance. In all of the country cases, training is not viewed as an end in itself; it is used as a support to other organizational or institutional changes that impact PFM. Effective capacity development requires well functioning organizations consisting of a trained, motivated and committed staff. While on the one hand it is necessary to build upon the capacities that exist, on the other hand it should not be neglected that also often individual capacities do exist that are detrimental to successful reform. These detrimental capacities are the skills individuals have accumulated often over many years on how to abuse the system for their own interests. As for the public sector in general, corruption, nepotism and embezzlement are major reform challenges and hindrances for a well functioning PFM. Effective capacity development in PFM reduces these impediments. This requires not only organizational restructuring, but also changes in personnel. Well performing staff has to be retained by offering competitive wages and other incentives; the hiring of new staff needs to follow meritocratic principles. Experiences show, that in some cases capacity development efforts in PFM could not lead to improved administration, because civil servants, who had been taking part in training programs, left their

positions in administration positions to enter into the private sector for remuneration reasons. The incentive structure within the public organizations has to be designed in a way that deters brain drain and allows for career opportunities in a fruitful competition.

**Box 6. Applied Training and Human Resource Development: Peru's Tax Administration**

Peru's tax administration was riddled with corruption and on the verge of collapse. The tax agency neither recruited experienced professionals nor provided training. As a result tax collection declined. Thus, the government decided to pioneer - with support of the World Bank - the concept of the semi-autonomous revenue authority "National Tax Administration Superintendency" (SUNAT), the first in Latin America. One key element was to implement radical personnel reform and to develop a plan for a comprehensive staff evaluation and replacement program.

All staff members, who were inherited from the previous agency, were given the choice of either opting for voluntary retirement or applying for a position in the new established SUNAT. Those who applied were subject to a three-phase exam. The first phase consisted of a psychological evaluation that focused on personality, intelligence, and moral judgement. The second phase evaluated knowledge, reasoning, and professionalism. The third phase consisted of personal interviews. Additional information from third party sources, such as the public register and the general accounting office, was also used to evaluate the suitability of existing staff for employment in the new superintendency. Only those who satisfied all these requirements were rehired. Despite strong resistance from the union and staff, SUNAT managed to carry out the initiative, which sheared two-thirds of its staff. Bringing the number of employees to the needed 2,000, the final step was to recruit about 1,000 new staff members through a rigorous selection process at Peru's most elite private universities.

But the staff evaluation and replacement program was just the beginning. As part of SUNAT's autonomy, it was allowed to operate under private sector labor laws, permitting the agency to design its own professional personnel system, which was seen as instrumental to the reform's success. To boost morale and efficiency, SUNAT decided to pay salaries based on comparable employment in the private sector. As a result the average monthly salary jumped from US-\$50 to US-\$1,000. The new salary policy also included a provision to maintain the competitiveness of SUNAT's salary structure relative to the private sector.

Source : World Bank

27. **Structuring project management roles realistically.** The form and quality of project management can also be an important consideration. The program needs to have competent staff with the authority to guide and facilitate decision-making at key junctures. In the Columbia FMIS case, it was concluded that it would be unrealistic to expect busy line managers to devote adequate attention to long term capacity development efforts. Instead, they formed a group of individuals who could be devoted full-time to implementation of project activities, but would work closely with line staff. The project also benefited from a coordination committee of senior officials who met frequently enough to resolve inter-institutional issues.

28. **Balancing local and international expertise in the implementation.** In Bangladesh composition of the implementation team was an important success factor. The team was comprised of current Government officials, international consultants, subcontracted national consultants, and retired senior officers. Experiences in Latin America, however, suggested that use of long-term consultants still has to be carefully managed. Some capacity development efforts have suffered from too many individual consultancies that become difficult to coordinate and control and costly to administer. As a result the Guatemala FMIS project was designed to keep the number of long-term consultants relatively small. And during Uganda's economic reforms of the early to mid 1990's, foreign advisors were assigned to specific departments of the MoF and were coordinated by one senior advisor.

**D. Coordinated, programmatic support from donors**

29. Governments are often faced with donor support for capacity development that is fragmented and inconsistent from donor to donor. Rather than being complementary, the assistance is often duplicative or competitive. Though the desire may be to respond to the needs of the partner country, many donor

practices are in fact intended to fulfill requirements of their own domestic stakeholders. This leads to separate funding mechanisms and pressure to show results within relatively short time frames. Funding is often unpredictable over the medium term and even technical support comes with significant restrictions. However, following a demand-driven approach within a donor harmonized context particularly needs to create flexibility for Government to decide for what purpose the donors' support is to be utilized.<sup>7</sup>

30. **Coordinating donor activities to support Government's plan.** In several countries, including Tanzania and Mozambique, donors have formed a coordinating group that supports government activities through a jointly-funded program. They have strived for common procedures and monitoring mechanisms. As they work together under Government's lead, the donors must reach compromises on the PFM issues that can be addressed within the time frames agreed with Government. There is still some room left for donors to target specific areas of interest, but on the whole support must fit within a common framework. Ideally, donor coordination goes beyond harmonizing single donor activities and the exchange of information. Donor coordination optimally includes establishing an institutionalized platform for both donors and partner countries, in order to also deal with the design and monitoring of the reform process. Donor coordination becomes even more important, but also more difficult, in countries with sophisticated PFM reform processes and a multitude of donors.

#### *Making donor approaches more compatible*

31. Capacity development binds existing capacities for reform in partner countries, but also donor capacities. Coordinating and aligning different donors' approaches will allow for efficiency gains in this respect. General benefits from donor coordination are, inter alia, an improved exchange of information and experiences, an acceleration of the reform process, decreased organizational costs, positive linkage effects and synergies, an improved impact of the donors' recommendations, an improved co-operation on the partner side as well as enhanced ownership and leadership. Coherent donor support allows donors to make more efficient use of their resources and increases the chances of successful capacity development, too.

#### **Box 7. Joined Forces: The GTZ/Danida Program "RAS", Nepal**

Beside Danida, GTZ has been assisting His Majesty's Government of Nepal (HMG/N) to support its revenue administration. In 1999 the Nepalese Ministry of Finance requested Danida and GTZ, who both had independent activities in the area of VAT respectively income tax, to enhance the capacities of the Inland Revenue Department (IRD), which has become in the meanwhile the merger of income tax and VAT administration.

Establishing the joint "Revenue Administration Support" (RAS) of GTZ and Danida could help to increase the effectiveness and transparency of the tax system through reforms in tax administration; herein, the implementation of an IT system by RAS has made considerable contributions. During the existence of RAS the rate of tax revenues could be increased on a higher scale than GDP growth; developing and implementing new Acts of Income Tax and VAT by RAS – combined with fitting administrative measures – has been key to this general trend. Furthermore, RAS contributes to the relation between state and taxpayers through extensive public information campaigns to create taxpayers' awareness. The joint activity also develops long-term training plans on management functions and operations.

As a crucial driver for success of RAS the coordination of GTZ and DANIDA, being locally initiated and executed, bases above all on a common understanding of technical cooperation as well as the staff's willingness and ability to intensively collaborate and flexibly react. Uniformly represented by both donors, RAS is considered a well-integrated and comprehensive Resource Center within the Nepalese IRD.

Source : GTZ, Germany

<sup>7</sup> Pooling arrangements including the provision of technical assistance (TA), for instance, involve harmonization of donor procedures and practices. The level of control for donor support by the partner country, thereby, can vary widely. Future experiences will show which level of the partner's control can reduce fragmentation and increase space for national ownership.

32. A common understanding of, inter alia, technical cooperation including e.g. similar objectives, as well as complementing reform areas of donors, compatible planning instruments and proceeding methods are helpful for donor harmonization. Ultimately, harmonizing donor activities needs to be locally initiated and executed based on the local staff's willingness and ability to intensively collaborate. Nevertheless, it has to be borne in mind, that harmonization itself generates costs. These costs need to be kept at a minimum. An optimal extent and form of harmonization very much varies on the respective country context including reform objectives to be achieved and specific circumstances.

***Supporting team spirit as a key element***

33. A necessary condition of successful donor harmonization is the existence and deepening creation of a „spirit of co-operation“ among donors. Personal skills like communicative abilities and creativity are key. Striving for synergies of co-operation instead of competing about dominance should characterize donors' common activities. This requires adequate capacities within donor organizations like a mental and practical flexibility to take care of other donors and to respond to changing circumstances.

34. **Showing flexibility in the timing of interventions.** Experiences show that donors can be flexible in setting the focus and timing of capacity development activities. Obviously flexibility is easier when both sides can keep focused on a common long-term objective and have realistic assessments of the potential obstacles. In Benin, for example, when an external shock affected the country's primary export product, the World Bank team shifted its efforts to helping government obtain a supplemental credit to the weather crisis. The donors also showed flexibility in their approach to working with Andhra Pradesh. First, they allowed the government space to delay addressing financial accountability issues until greater budget predictability was achieved. Then, once government was ready to consider diagnostic work it insisted on conducting the study itself through a local institute. The donors' flexibility in supporting this approach resulted in a quality report that had greater government ownership of the findings than would have been likely had it been a donor product.

35. Maintaining a medium term perspective, with realistic expectations of short-term achievements. The platform approach in Cambodia (as mentioned above) builds upon the concept of capacity development being a multi-year and phased undertaking. Each phase or platform need not be elaborated in the same level of detail however. Design and implementation is centered around activities required to achieve the PFM performance objective that is set out as the first platform – i.e., improved budget credibility. This sets a boundary for what donors can consider and focuses both government and donors upon an agreed path. Achieving the first platform is a pre-condition for moving on to the next platform.