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Enhancing the Capability of Central Finance Agencies

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A well-organized and effective finance ministry and its associated central finance agencies (CFAs) are essential to good fiscal outcomes. Recent studies of CFAs in selected low-income countries demonstrate that their organizational structure varies widely and that decision making on public finance is strongly influenced by political economy factors. This note presents some common themes arising from the case studies and provides some descriptive evidence about the organizational structure of the CFAs. This note also includes evidence of a “U-curve” pattern in the development of the organizational structure of CFAs over the long term. It confirms that political economy analysis, though difficult to apply in practice, is highly relevant in the development of reform strategies for strengthening CFAs and public financial management systems.

CFAs are not a single organization or entity of government, but a group of ministries and agencies¹ of which the ministry of finance (MoF) is usually the most prominent, with collective responsibility for the design and execution of a country’s wide array of financial and fiscal functions.² In this note, the term “CFA” is used as shorthand for ministries and agencies that play a significant role in undertaking such functions. These functions can be divided for convenience into the 16 categories shown in table 1.

The allocation of roles and responsibilities for central finance functions among government agencies varies substantially from country to country and results in higher or lower degrees of fragmentation. There is no “best practice” model.³ In some countries, the MoF employs more than 100,000 staff, in others, less than 100. Such huge variations are not only related to easily quantifiable factors such as population size and the size of the public sector, but also to a range of informal and non-technical factors—described in the present study as *political economy* factors.

This note addresses the important but little discussed issue of how the organization and management of CFAs could evolve

Table 1. Central Finance Functions

Macroeconomic forecasting, analysis, and fiscal policy
Tax policy
Budget preparation and analysis
Public investment management
Aid and debt management
Financial assets and liabilities
Intergovernmental fiscal relations
Treasury and cash management
Accounting and reporting
Internal auditing
Public procurement
Civil service pay
Financial sector regulations
Financial framework for managing state-owned enterprises
Tax revenues and customs administration
Public financial management reform coordination

Source: Authors’ compilation.

in light of political economy considerations.⁴ Starting with the work of Dressel and Brumby (2009), which sets out a political economy framework for analyzing CFAs, this note highlights some common themes and features that were elaborated in a set of case studies of 10 low-income countries (LICs).⁵ In addition, the note presents some descriptive findings based on a database of CFAs in 55 countries at various stages of development, and concludes with a presentation of the case studies' policy implications.

Methodological Framework

The framework summarized in figure 1 defines five key interfaces for CFAs—with formal political institutions, administrative institutions, civil society, external actors, and within the CFAs themselves.

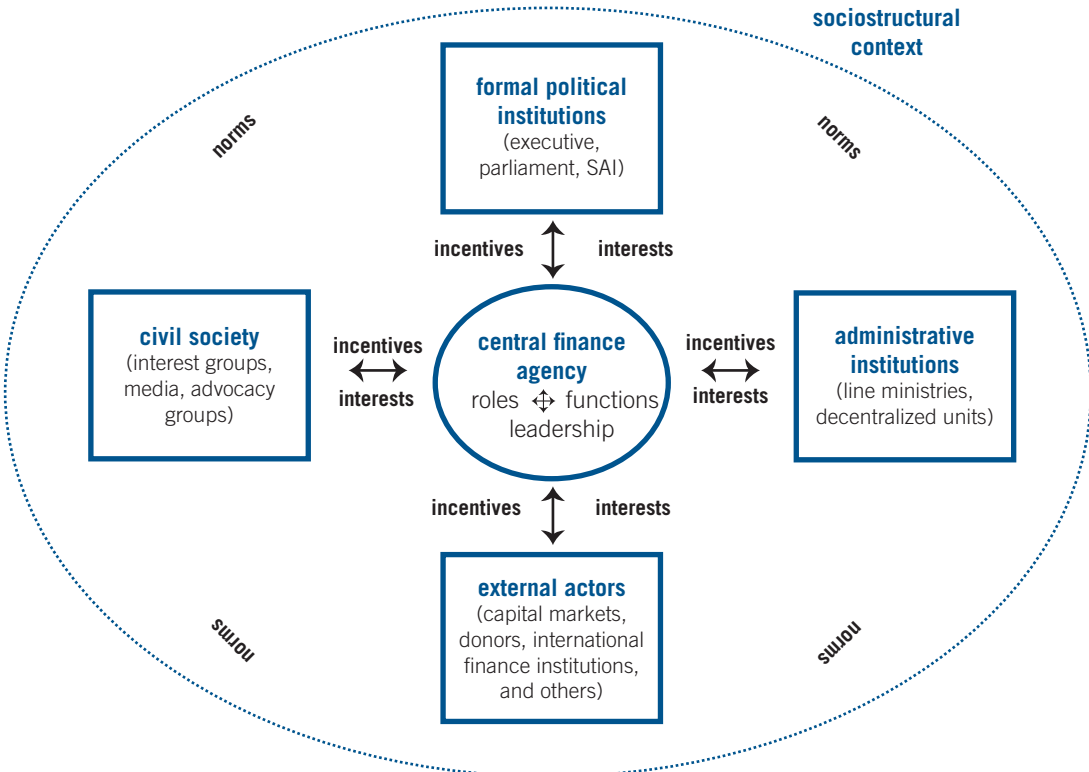
The framework makes an important distinction between the capacity and capability of CFAs. “Capacity” refers to the volume or scope of inputs such as human resources or ICT systems. “Capability” focuses on how such volumes can be converted into better performance through mechanisms such as clarifying roles and responsibilities in performing CFA functions; strengthening arrangements for coordination and information sharing within and across CFAs; clarifying relations with line ministries, civil society groups, development partners, and other stakeholders; improving the management of internal business processes such as decision-making hierar-

chies, corporate planning, and information systems; and strengthening the management of human resources and internal incentives.

In practice, many countries have focused attention on strengthening capacity, with less emphasis on strengthening capability. The two concepts are typically linked: where capacity is low, capability is also likely to be limited. However, this relationship does not hold in all cases: a weak configuration and/or organization of inputs and a high-cost operating environment, perhaps also marked by institutional constraints such as a finance minister who lacks a power base within the government, may mean that even when capacity is high, capability may be low. In other countries, the reverse situation of low capacity and high capability may arise: finance functions are well organized and professionally staffed and business processes are efficient, but outcomes are constrained by limited inputs.

It can be argued that conventional instruments for analyzing public financial management (PFM) systems—notably the Public Expenditure and Financial Accountability (PEFA) Assessment Framework and much technical assistance work carried out by the international financial institutions (IFIs)—have focused primarily on the formal, technical characteristics of these systems and have paid too little attention to analyzing the important political economy factors noted above. However, these factors often help explain why many new initiatives for

Figure 1. The Political Economy Environment of CFAs



Source: Dressel and Brumby 2009 (figure 1).

reforming PFM systems and CFAs fail to be implemented fully, and why de jure reforms based only on changes in formal legal systems tend to be more successful than de facto reforms based on actual changes in behavior, which lag behind (Andrews 2010).

The case studies conducted by the World Bank (2011) help to fill a gap in the literature on strategies for reforming PFM, namely insufficient analysis of the institutional and political economy foundations of such strategies. Such analysis is important to ensure that initiatives to strengthen CFAs and PFM systems are politically tractable as well as being technically sound. Reforms should be compatible with the incentives of the national authorities and donors to ensure that reform implementation is not constrained and does not experience the setbacks that often occur in developing countries.

Evidence from the Case Studies

World Bank (2011) includes case studies of 10 LICs, 6 of which were in the Africa region (Benin, Cameroon, Chad, Ghana, Rwanda, and Sierra Leone), 2 in East Asia and the Pacific (Mongolia and Tonga), 1 in Latin America and the Caribbean (Nicaragua), and 1 in the Middle East and North Africa (the Republic of Yemen). This section summarizes some of the main lessons emerging from these studies.

First, in several of the countries studied, the head of state plays an unpredictable and sometimes capricious role in making executive decisions on the budget and financial policy. While such powers are normally exercised within the framework of the constitution and budget law, they are not always compatible with the idea of an efficient and transparent budget process, as described in the literature on public finance. An important implication of this analysis is that large tracts of the fiscal process are likely to be outside the direct influence of the finance minister and off limits from a reform perspective.

Second, it was observed that, in some countries, the head of state uses his political authority to divide the financial power attributed to the minister of finance among several ministers. Such actions are often taken to avoid the accumulation of excessive authority in the hands of one person, and to preserve the discretionary powers of the president over spending and revenue collection. Another reason is that ministerial portfolios not only provide access to rents, but also accommodate factions within the ruling coalition. Such tactics of “divide and rule” are not unknown in developed countries,⁶ and seem to be quite commonplace in less-developed countries. In some LICs, especially early in the tenure of a new head of state, the reverse phenomenon can be observed: the head chooses to use the finance minister as an ally in building the economic and financial power of the state, and gives the minister strong powers. Such an alliance can also give a strong momentum to the reform process.

Third, several of the case studies involved functional and organizational reviews of the MoF and its relationship with other

CFAs. The internal capability of an MoF was broken down into the following six dimensions: (i) organizational structure; (ii) attraction and retention of staff; (iii) performance management; (iv) decentralized decision making; (v) change management; and (vi) information technology. Issues of interest that emerged from the case studies include inadequate staff records, poor systems for recruiting and retaining staff, ineffective performance management, inefficient top management structures and over-hierarchical decision-making processes, and ineffective use of information and communication technology (ICT) systems.

Fourth, the case studies confirm the view that changing the organization of finance ministries and CFAs is a difficult process that is likely to meet opposition from both politicians and staff. Moreover, there is an absence of international benchmarks, guidelines, and standards indicating the desired organizational structure or number of staff required to implement key finance functions. In advanced countries, these arrangements vary widely from country to country depending on the legal and administrative traditions and practices.

Fifth, the studies tend to confirm results of other work: weak coordination among donors—and between donors and their clients in finance and planning ministries—is a major problem in designing and implementing coherent strategies for reforming CFAs and PFM systems (Allen 2008; de Renzio 2011). There is a tendency for donors to bundle together a large number of initiatives in a single PFM reform strategy or lending operation,⁷ without giving due attention to the government’s capability to implement the measures concerned; donors also tend to be too optimistic about how long it will take to implement reforms. In reality, it is the marginal improvements in PFM that are important rather than the overall plan, which is often too elaborate and overengineered. Moreover, securing large loans from donors may improve the recipient country’s status regionally and internationally, as well as providing a valuable new source of economic rents.

Finally, the study confirms evidence set out in other studies—for example, de Renzio (2011) and Allen (2008)—namely that reforms of CFAs and PFM in many LICs are strongly influenced by donor requirements, with insufficient government “ownership.” Moreover, experts from advanced countries, hired to advise on the technical aspects of PFM reforms, may recommend finance ministers to proceed with reforms that are insufficiently related to local needs and capabilities.⁸

Analysis of the Organizational Structure of CFAs

In addition to the case studies described above, data on a wider sample of countries were collected on the allocation of central finance functions and related activities among the MoF and other CFAs, as well as on staffing issues and ICT usage.⁹

A core objective of the empirical analysis is to consider the extent to which CFA activities are concentrated in the hands

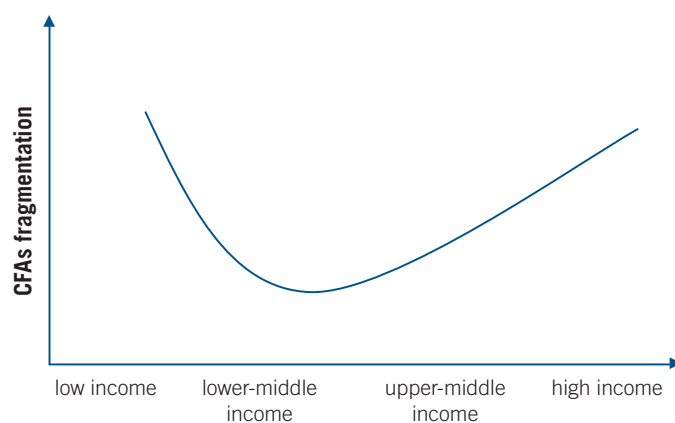
of one agency—usually the MoF—and to what extent they are distributed among other agencies of government. For this purpose, two measures of fragmentation were used: a *narrow definition* that measures the proportion of finance activities that are carried out by the central departments and units of the finance ministry and a *broader definition* that measures the proportion of activities carried out by the finance ministry and/or the subordinate agencies that report directly to it. The analysis also draws a distinction between *policy* activities (such as budget formulation and tax policy) and activities that are largely *operational* (such as tax collection and procurement transactions).¹⁰

It can be argued that, as countries move from the lowest income group to the highest, the fragmentation of CFAs will exhibit a U-shaped pattern such as that shown in figure 2.

At low-income levels, countries often have highly fragmented CFAs in which control of public finances is divided according to powerful political groups and, as discussed, by heads of state who deliberately fragment the authority of the finance minister to boost their own authority. Dispersed manual systems of accounting, reporting, and financial control tend to reinforce this phenomenon.

As countries move to middle-income status, pressures to consolidate financial activities within the finance ministry increase, often with the active encouragement of the IFIs. For example, many countries in Central and Eastern Europe went through this process in the 1990s after the breakdown of the former Soviet Union. Soviet-style central planning bureaus were dismantled, and central financial control systems reinforced. The goal of joining the European Union (EU) was a further incentive for these countries to centralize finance functions, because they had to comply with the strict financial conditions (on internal control, audit, and public procurement) imposed by EU rules. Policies such as integrating the budget and planning processes, bringing extrabudgetary funds within the budget, and consolidating government bank

Figure 2. CFA Fragmentation across Income Levels



Source: Authors' illustration.

accounts within a treasury single account are other examples of this centralization trend. This trend has both a technological aspect (to increase overall fiscal control) and political aspects requiring greater accountability and transparency: the emergence of a professional middle class holding the government accountable for fiscal performance; a less dominant role for rent seeking in driving budget allocations; the rise in power of the finance ministry as an institution of government; the increased political importance of the annual budget; and increasing reliance on international capital markets as a source of finance.

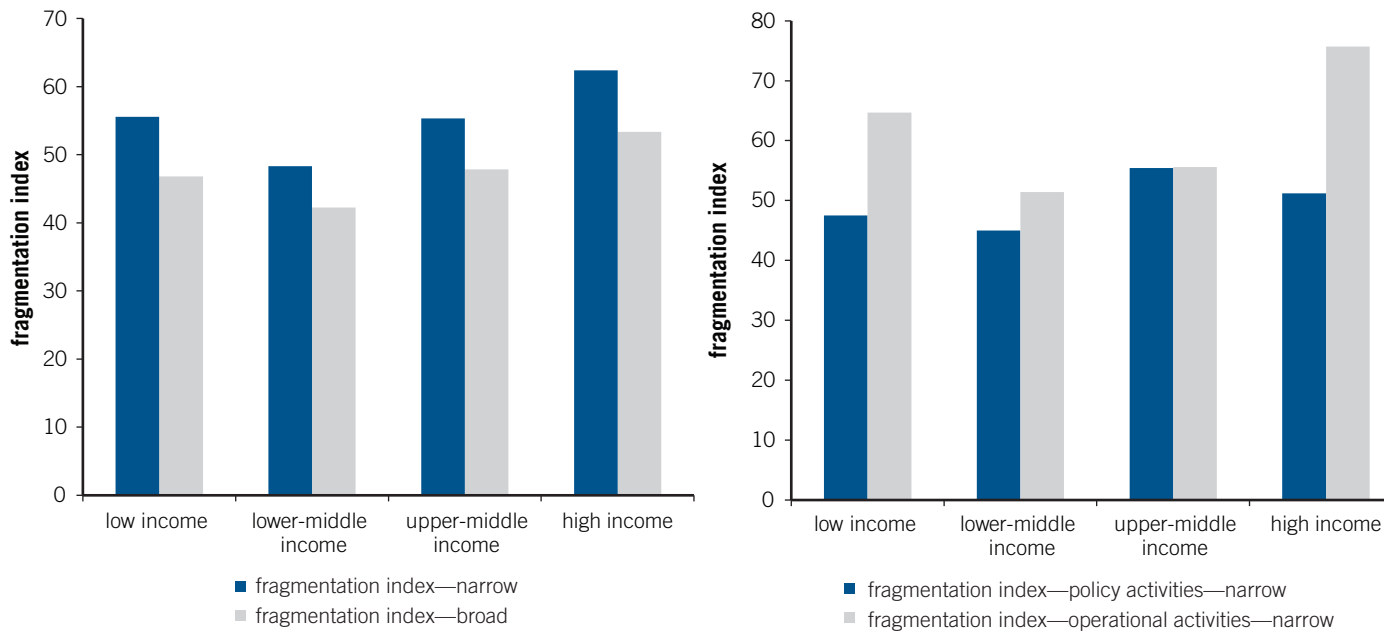
In high-middle-income and advanced countries, finance ministers are unlikely to relax their grip on central controls of the budget process unless political conditions require them to do so. However, even in the budget area, the role of the finance ministry may change from directly operating the systems concerned to an oversight and monitoring function, while direct operations are transferred to line ministries and/or subordinate agencies responsible for treasury and procurement functions. In many operational areas, finance ministers may delegate operational responsibility for the activities concerned to subordinate agencies under their supervision. Fragmentation may therefore increase again, as the “managerial” culture and decentralization spread, new agencies are created, and further computerization takes place.

This historical perspective of fragmentation has important policy implications.¹¹ LICs should be encouraged to centralize their finance functions and be cautious about enacting policies—for example, fiscal decentralization—that do the reverse. Middle-income countries should be encouraged to gradually devolve authority for financial decision making to the agencies responsible for specific functions and programs, but without creating undue stress on their financial systems. For example, too rapid growth of autonomous government agencies has been a feature of developments in many middle-income countries, including in Eastern Europe and Central Asia, but without adequate safeguards and controls this growth can threaten the overall financial stability of these countries. Devolution should go hand-in-hand with the building of institutions and the development of credible anticorruption policies.

Some evidence in support of this interesting U-curve hypothesis is provided in panel A of figure 3, where both the broad and the narrow index reflect the U-curve. As expected, panel B reveals that operational activities are in general more fragmented than policy activities across income groups. Panel B also shows that, while the fragmentation of operational activities follows the U-curve, the curve for policy activities is flatter. These tentative results need to be confirmed with more comprehensive data.

Figure 4 indicates that the allocation of roles and responsibilities for central finance activities among the finance ministry itself and other government agencies varies substantially from

Figure 3. CFA Fragmentation across Income Groups



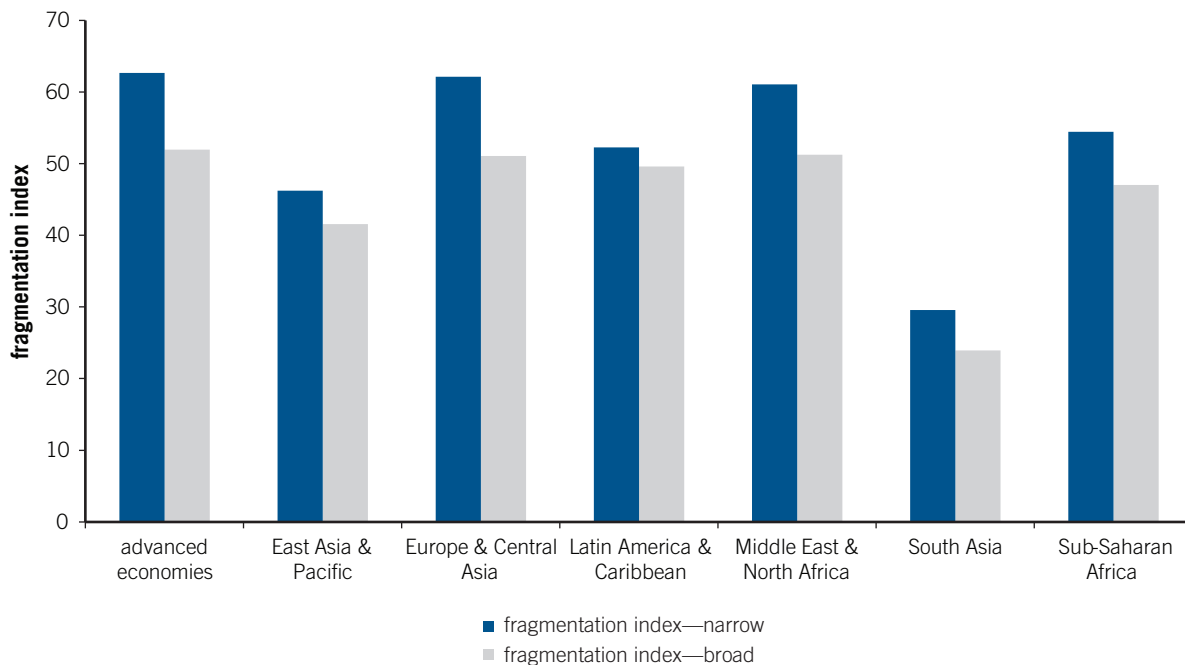
Source: Authors' illustration.

region to region.¹² Of the six regions studied, the Middle East and North Africa and Europe and Central Asia show the highest levels of fragmentation, and South Asian countries the lowest. It should be remembered that the small sample size is a limitation for such interregional comparisons.

Finally, one would expect the fragmentation of CFA activities to be higher in resource-rich countries than in non-resource-rich countries because resources constitute a poten-

tially huge additional source of fiscal revenues—and fiscal risk—that need to be managed, sometimes involving special instruments such as sovereign wealth funds. In the case of fragile states, the reverse is true. As discussed in a recent World Bank study (Fritz, Hedger, and Fialho Lopes 2011), there is often a unique opportunity in such countries to consolidate fiscal functions and activities within the finance ministry because of the emergency status of public finances, the fragility

Figure 4. CFA Fragmentation across Regions



Source: Authors' illustration.

of political groups, and because consolidation is usually insisted upon by donors and welcomed—or at least acquiesced to—by the government as a requirement of donor support. Data analysis provides tentative support for these hypotheses (results not reported).

Policy Implications of the 10 CFA Case Studies

The World Bank (2011) synthesis report shows that political economy analysis of CFAs is highly relevant—indeed essential—to the design and implementation of new initiatives to strengthen CFAs. An important implication of this finding is that political economy analysis is valuable in filtering out reform proposals for which political economy factors are favorable to success from those where there is a high risk of failure. One potential method of analyzing such factors may be through case studies similar to those famously developed by the Harvard Business School for analyzing how companies resolve structural, institutional, and human resource issues that constrain their growth and productivity.¹³

Second, the case studies support work by Andrews (2010), de Renzio (2011), and others and demonstrates that “best fit,” “good enough governance” and second-best solutions, as opposed to best practice solutions, provide a better approach to reform and need to consider the institutional environment as well as technical conditions. A change in emphasis is required in cases where international finance institutions or bilateral donors are providing support for building stronger PFM systems in developing countries. Such a change in emphasis is the reverse of most current practice: technical solutions would be proposed only after a detailed review of institutions has been carried out and solutions tailored to the specific political and institutional environment of the country concerned. Lending instruments could be developed (such as the Bank’s Performance for Results Framework) that facilitate such an approach. Reforms should only be proposed when they are compatible with existing institutions and incentives.¹⁴

Third, the data provide some support for the U-curve hypothesis that historically CFAs may go through various stages of fragmentation in their evolution from low-income to high-income status. The database provides useful information on the comparative fragmentation of CFAs across regions and countries, the number of staff working in central ministries of finance including a breakdown by skills and gender, and the use of ICT systems. If further developed, the database would provide a valuable research tool.

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Endnotes

1. These typically include, in addition to the MoF, certain departments of the central bank and the ministry of economy; line ministries; subordinate agencies of the MoF with responsibility for functions such as tax collection, customs administration, debt management, and public procurement; and organizations that are external to the executive branch such as the legislature and the external audit authority.

2. In the so called “limited access order” countries, the role and responsibility of the finance ministry largely reflects the consensus of the political and business elite on how to use public resources to help maintain the prevailing political order. In contrast, in “open access order” countries, the finance ministry’s role and responsibilities are largely defined by the goal of maximizing public resources for the public good.

3. Allen and Kohnert (forthcoming) provide a discussion on comparative CFA structures in a range of advanced countries, with special reference to France, Germany, and the United Kingdom.

4. The note is based on the findings of a study of CFAs in low-income countries that was financed jointly by the Bank-Netherlands Partnership Program and the World Bank during 2008–11. The full results of the study are included in a synthesis report (World Bank 2011).

5. World Bank (2011) describes these case studies in detail.

6. For example, countries such as Australia, Brazil, Canada, France, the Republic of Korea, Turkey, and the United States all have divided finance ministries. In most of these countries, political factors—notably an attempt to dilute the authority of the finance minister—played an important role in the decision to split these functions (Allen and Kohnert forthcoming).

7. The use of “basket funding,” in which donors pool their resources into a single fund and slice up the reform program

into pieces for which each of them take responsibility, may exacerbate this tendency for reform programs to grow beyond the capability of either the donors or the client to implement them effectively.

8. A related issue is that countries may not have the human capacity to implement the reforms that are urged on them by the donor community. As a result, it is commonly observed that CFAs supplement their regular staff positions with consultants and advisors financed by the donors. Such advisors often take responsibility for line management positions and once hired are difficult to move out. More important, they may permanently weaken the capability of the CFAs to build local capacity to fill the positions concerned.

9. Of the 110 countries that were originally targeted, only 55 countries responded to the survey, while responses to questions on staffing and ICT systems were 22 and 30, respectively.

10. More formally:

$$\text{Fragmentation Index}_i = \left(1 - \frac{\sum_1^n A_i}{n-p}\right) * 100,$$

where A is an activity carried out uniquely by the MoF, n is the total number of activities, p is the number of activities that are not systematically carried out or do not exist, and i is the subscript indentifying the index definition. Thus, a higher index value will reflect a more fragmented finance ministry. The *broad fragmentation index* is computed in the same way, but A now includes activities that are carried out primarily by a subordinate agency of the MoF, with or without the contribution of the MoF. Similar indices have been computed separately for policy and operational activities.

11. Because the advocated reform approach is based on the notion of “best fit” solutions linked to specific country circumstances, these policy implications need to be interpreted broadly and flexibly.

12. Andrews (2010) shows that countries that exhibit good outcomes can have very different governance structures, challenging the idea of one best-fit model for public financial management systems and government structures in general.

13. For example, players representing different organizations—the finance ministry, line ministries, parliament, civil society, and others—could be brought together for the implementation of a specific policy initiative (for example, a new pension scheme or a proposal to reform local government finance) or a structural reform (such as establishing an integrated revenue authority) to review how objections to such a reform, and constraints to implementation, can be resolved, and how incentives to facilitate implementation can be aligned.

14. Hasnain (2011) provides a useful example from Mongolia, where the parliament exerts a powerful influence on public finances and is able to block important reforms if they do not meet the perceived needs of constituents. The paper argues that the parliament may be persuaded to support fiscally valuable reforms, for example, the development of an economically efficient system for allocating development grants, if their access to constituency development funds—which has a low fiscal cost—is also preserved.

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