

# Public Finance and Administrative Reform Studies



## Good Financial Governance – Good Governance in Public Finance

Fiscal Studies No. 3

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State and Democracy  
Public Finance Reform

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## List of Abbreviations / Acronyms

AAP	Accountability Assessment Programme
BMZ	Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung (Federal Ministry for Economic Cooperation and Development)
CFAA	Country Financial Accountability Assessment
CIM	Centre for International Migration
CPAR	Country Procurement Assessment Report
DAC	Development Assistance Committee
DANIDA	Danish International Development Agency
DED	Deutscher Entwicklungsdienst (German Development Service)
DFID	Department for International Development
EC	European Commission
EU	European Union
GDP	Gross Domestic Product
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (GmbH) (German Corporation for Technical Cooperation)
HIPC	Heavily Indebted Poor Countries
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IT	Information technology
MTEF	Medium Term Expenditure Framework
ODA	Official Development Assistance
ODI	Overseas Development Institute
OECD	Organization for Economic Cooperation and Development
PBA	Programme Based Approaches
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PRS (P/P)	Poverty Reduction Strategy (Programme/ Paper)
PRSC	Poverty Reduction Strategy Credit
SADC	Southern African Development Community
SAI	Supreme Audit Institution
SBO	Senior Budget Officials
SWAp	Sector Wide Approach
TC	Technical cooperation
UN	United Nations
VAT	Value Added Tax

## Summary

**From Good Governance to Good Financial Governance.** The Good Financial Governance approach sets out the principles that have prevailed in the field of Good Governance in recent years in terms of public finance.

- *Legitimacy* means the democratic legitimisation of financial policy decisions including proper public participation and ensuring gender balance.
- *Accountability* is crucial to Good Financial Governance. It involves government's obligation to be accountable and thus requires government activities to be transparent. How effectively and efficiently public funds are used depends very much on the extent to which society and its citizens can hold the state accountable and act accordingly.
- *The rule of law* requires public financial policy and management to operate within a legal framework that is generally valid, fair and impartial. The rule of law governing public finance primarily ensures that funds can be reliably forecast and controlled.
- *Performance* describes the willingness and ability of state bodies and institutions to fulfil their tasks. Efforts to achieve better performance in terms of good financial governance essentially mean broad capacity development of public institutions with respect to their functions in dealing with public resources.
- *The development orientation of government* concerns the fundamental values governmental action is based on: social justice, ecological sustainability and the principles of market economy. These must be reflected in both the national revenue system and the pattern of public spending.

The Good Financial Governance approach clearly demonstrates how far-reaching and politically sensitive reforms of public finance are. On the other hand sustained successes in state development cooperation cannot be achieved without minimal good financial governance standards. This is why interest in financial policy and management in development cooperation has greatly increased in recent years.

**The higher significance of public finance** is demonstrated by numerous international agreements including the Declarations of Rome and Paris, the HIPC Initiative and the Monterrey Consensus. Public finance – in particular public expenditure management, public revenues and government procurement – has taken on a key role and this is principally due to the Declaration of Paris on aid effectiveness of development cooperation. This process deals with, among other things, broadening partner countries' space for further development by means of higher revenues, the creation of a transparent budget management and the establishment of appropriate implementation structures in public finance as a precondition for the harmonised provision of donor funds. This increased significance stems first from the insight that joint financing models such as budget support require a minimum of reliability of public financial management to limit fiduciary risk. Furthermore, it has increasingly been recognised that Good Financial Governance has a marked influence on the development process in general. A large number of initiatives and agreements have been adopted in recent years to improve the financial performance of the partner countries. There is agreement that successful reforms in this area can only be achieved if governments themselves are responsible for the reform processes.

**Stakeholders involved in the implementation of good financial governance.** Delivering Good Financial Governance involves all individuals and government units whose function is to regulate, organise and control the use of public resources. Alongside government institutions, – Ministry of Finance, revenue authorities, financial control institutions, line ministries and downstream authorities –, Parliament, civil society and the donor community are important. Actions of these players are interlinked in a complex manner, and are determined by the cultural conditions of the country which, in turn, significantly affect the structure of the reform process.

**Organisation of reforms.** The main areas of reform leading to Good Financial Governance are the revenue system, the expenditure planning and management system and the control system. Reforms leading to Good Financial Governance are of a highly sensitive political nature, extend to virtually all institutions that work with public funds and demand open, critical cooperation between the executive, Parliament, control authorities, civil society and the donor community. It is obvious, therefore, that reforms in this area tie up considerable resources and can only be implemented over a correspondingly long period of time. Certain rules have to be observed when offering advice on these kinds of reform processes.

- “No One Size Fits All” (NOSFA) principle – advice must be adapted to conditions in the partner country.
- Prioritisation of reforms and timing is important and, above all, dependent on the extent of the problems and the capacities of the local administration.
- If resources are limited reforms must be pursued sequentially, as a manifold of reforms may hinder even attainable success.
- The design of reforms as institutional changes and therefore an appropriate change management is important.

**Challenges and reform requirements on the revenue side.** Good Financial Governance on the revenue side means that sufficient external and/or own funds are provided in a predictable and regular manner to cover planned expenditure, and that funds are raised taking into account taxpayers’ ability to pay. Moreover, this entails the tax authorities working in accordance with the rule of law, being accountable to the public and capable of doing their job. The situation in most developing countries is far from ideal. Reforms should mainly address the following points:

- Stabilising external financial inflows by increased predictability of donor funds.
- Increasing own revenue by:
  - Tax reforms that are feasible in the national context, tax legislation that is as little bureaucratic as possible, widening the tax base by abolishing exemptions and promoting growth.
  - Improving tax administration by concentrating on major tax sources, capacity building and improving technical systems.
  - Considering the tax culture and improving political participation.

**Challenges and reform requirements on the expenditure side.** Good Financial Governance on the expenditure side requires regulation-based, effective and efficient planning and implementation of public expenditures in line with political priorities that reflect the population's preferences and requirements, e.g. in accordance with a development strategy created with the help of public's participation. As it is the case on the revenue side expenditure management in the majority of countries lags well behind what is needed. The following measures must be considered on the expenditure side:

- Budget planning must refer to all public expenditure, i.e. result in a comprehensive budget. Donors can help here by avoiding project budgets that are administered in parallel.
- The credibility of budget planning depends on the plausibility of expenditure estimates. These require reliable forecasts based, firstly, on macroeconomic stability and reliable donor contributions and, secondly, on the ability of the administration as a whole to plan funding requirements appropriately. Furthermore line ministries must be capable of planning their funding requirements appropriately. This is an enormous challenge for capacity building.
- Medium term financial planning is imperative but must not overburden the limited capacities and resources of the institutions concerned.
- Information systems are indispensable and must be designed in a reliable and user-friendly manner in line with country requirements.
- Harmonisation of public expenditure with the needs of the population additionally requires systematic statistics. At local level some means for direct participation in budget planning should exist.

**Challenges and reform requirements within the control system.** Good Financial Governance within the control system demands a statutory framework for accounting, auditing and control that is both functional and sufficiently well known, as well as good coordination and cooperation between all the institutions constituting the control system. The following aspects must be considered to ensure effective control of public finances based on the principles of good financial governance.

- Appropriate record-keeping must reliably reflect material financial transactions, at all times maintaining a complete audit trail stored so that access is allowed as required.
- The data should be used for future budget planning as well as for internal audits and financial reporting.
- Effective external control depends on reliable source data. Thus reforms that only apply to the (Supreme) Audit Office are sure to be too limited.
- Even with a good performance of public administration, good financial governance arises only if audit results can be used by the public to hold the government accountable in the event of abuse of funds and an independent judiciary can secure condemnation under the rule of law.

**Capacity building in public finance reform: the German Development Cooperation approach.** German Development Cooperation has extensive experience implementing individual aspects of good financial governance going back many years. The characteristic

features of the experience gained to date are “connectivity” and partner-orientation. The latter is principally supported by placing experts within partner countries’ administrations for long periods. The national and international networking of German and European tax administrations, research institutions and specialised regional organisations in the budget and tax sectors should be emphasised as an additional special feature of German Development Cooperation.

The good financial governance approach finally closes a gap which had existed to date also in German Development Cooperation: only targeted application of the principles of Good Governance to all subsystems of public finance, i.e. a systemic good financial governance approach, will enable sustained public finance reform in developing countries.

## 1. Introduction

For years, discussion of development policy has stressed the significance of Good Governance as a precondition and a focal point for development. It was the Secretary General of the United Nations, Kofi Annan, who said that “Good governance is perhaps the single most important factor in eradicating poverty and promoting development”. By contrast, discussion about public financial management in developing countries was only opened up to a broader audience much later, essentially related to the debt relief initiatives at the end of the 90s and donor efforts at harmonisation through programme-oriented budget support.

In the way public funds are used, the quality a country’s governance is expressed most significantly. Whenever State development programmes are linked with the use of public funds – and this has been the case for the majority of reforms and projects since the beginning of development aid in the 1950s – the way public funds have been used in the country concerned has significantly determined their success, efficiency and sustainability.

In this paper our goal is to apply the principles that have prevailed in the field of Good Governance in recent years to the field of public finance and thus to develop a “Good Financial Governance” approach.

This is necessary, on the one hand, to enforce the systemic character of public finance and its management. Whenever public finance is discussed related to Good Governance, then the discussion usually centres on certain aspects, e.g. corruption and control by the Audit Office. Often discussion about reforms tend to concentrate on one single institution such as the Ministry of Finance or the Audit Office without taking into account the fact that in practice public financial management concerns almost every authority in the country.

On the other hand, expert discussion of public financial management reforms in developing countries frequently disregard the political framework provided by Good Governance principles. As a result the political dimension of reforms – and thus the process of their implementation – is often underestimated or the emphasis is placed rather on technical optimisation, overestimating the capacity of the partner countries’ administrations.

The good financial governance approach addresses both sides: the international development community who, due to the progressing programme-orientation of development cooperation, is increasingly confronted with the systemic links between implementation of sector specific and of macro programmes, and public finance specialists, whose work generally receives greater attention as well as being assessed according to the evaluation criteria of development cooperation.

This paper seeks to allow learning from one another. It is based on the presentations and results of the workshop on “Good Financial Governance: How to Ensure the Accountable Use of Public Funds?” at the Eschborn Dialogue 2004 on the subject of “Good Governance – State and society shaping development”<sup>1</sup>. In this case, theoretical and practical contributions by experts in the field of public finance and those with all-round experience in the field of development cooperation laid the foundations for the approach, which has subsequently been developed in the course of various discussions. This paper documents the status of the debate.

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<sup>1</sup> An overview of the presentations can be found in the appendix.

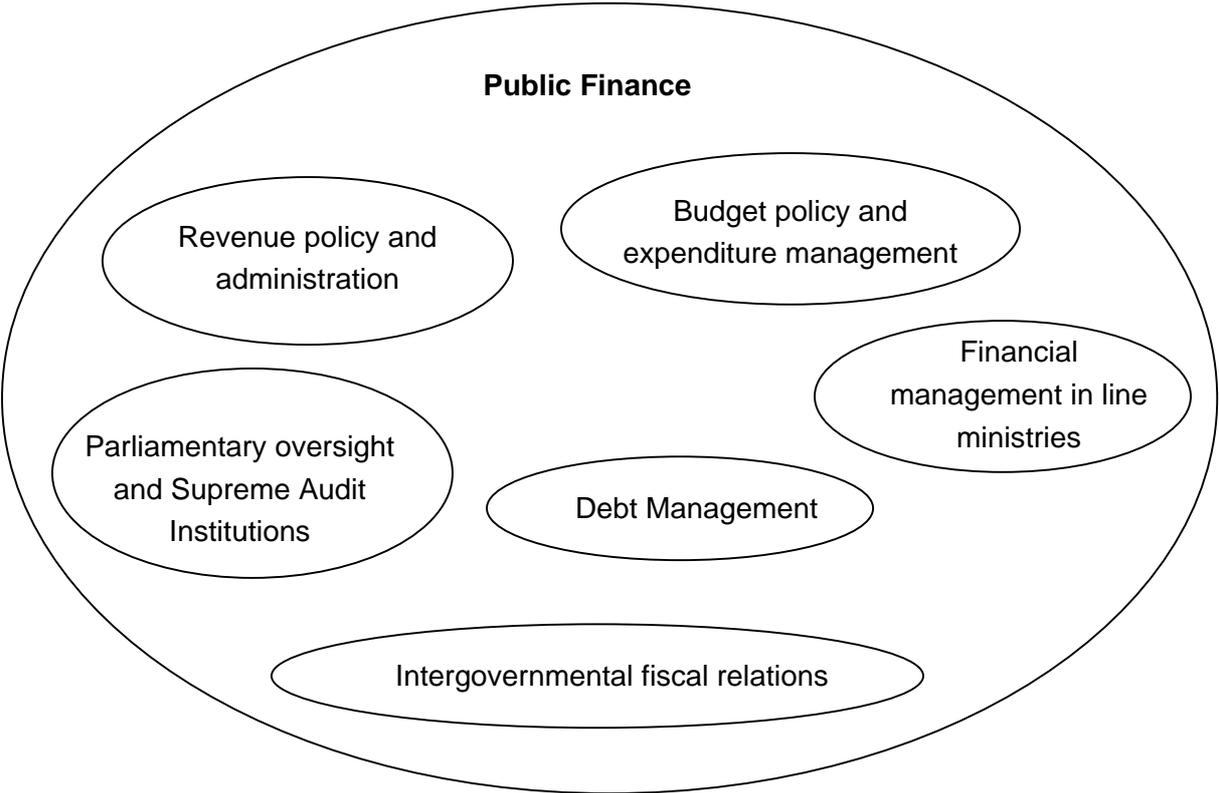
The paper starts developing the framework in the part one: the principles for Good Governance for public finance are set out, then the good financial governance approach is outlined. The growing interest in public finance in developing countries is explained and the participating institutions and players described. In the second part, the implementation of the approach is described: following a general introduction to the most useful timing and content of reform processes in public finance, the major challenges and the need for reform on the revenue, expenditure and control sides of the system from the point of view of good financial governance are formulated. Finally the contribution of the German Development Cooperation regarding the respective reform processes is described.

**2. Good Financial Governance:  
Approach to and integration of development policy**

**2.1 From Good Governance to Good Financial Governance**

For many years now Good Governance has been recognised as a central element of the promotion of development by partner countries and donors. This is not least emphasised in the millennium declaration. Perceptions and definitions of Good Governance differ internationally between institutions, albeit not significantly. There is a broad consensus concerning the general principles, i.e. legitimacy, accountability, the rule of law, performance and development-oriented national government, in particular in terms of social justice<sup>2</sup>. The BMZ (the German Federal Ministry for Economic Cooperation and Development) stresses the significance of a political understanding of Good Governance for German development cooperation<sup>3</sup> and emphasises the key role of proper public financial management for the planning and implementation of development-oriented policies<sup>4</sup>. This view essentially points at the major significance of Good Governance for public finance<sup>5</sup>.

**Figure 1: The system of public finance and its sub-systems**



Good Financial Governance puts the principles of Good Governance in definite terms for the public finance system and its subsystems (see figure 1). Thus it includes all areas of public

<sup>2</sup> BMZ (2002), page 8 ; Fritz, Meyer (2004), page 2f. ; UNDP criteria in accordance with Graham et al. (2003), page 3  
<sup>3</sup> BMZ (2002), page 8  
<sup>4</sup> BMZ (2002), page 14  
<sup>5</sup> BMZ (2002), page 13

financial management - policy-formulation as well as administration and control of state revenue and expenditure - in accordance with the principles of Good Governance. These, each first in general terms and then with specific reference to public finance, are examined below.

**Legitimacy** refers to the interaction between government and citizens. The totality of decisions, rules and regulations must be democratically legitimised. Citizens should participate directly or indirectly, e.g. via associations or other civil society organisations, in decision-making processes in the areas of their concern. The principle of legitimacy also involves gender equality in participation in society's decision-making processes, which is not necessarily guaranteed by general, democratic representation.

In public financial policy and management, the most important interfaces between citizens and state are taxation and the allocation of public resources. Taxation can be arbitrary and illegitimate, sometimes even going hand in hand with violations of human rights<sup>6</sup>. However, the main challenge meeting the principle of legitimacy is the process of allocating resources within the budget. Good Financial Governance should bring up a budget that reconciles political priorities with citizens' needs and preferences. This requires democratic legitimisation and a functioning system of political participation. Decision-making processes close to the people and, as result, local provision of public goods and services, also require a minimum level of decentralisation of political decision-making, budget implementation, revenue (taxes and fees) and control mechanisms.

**Accountability** means, broadly defined, that individuals and organisations can be held responsible for performance<sup>7</sup>. Financial accountability means the obligation of anyone dealing with public funds to report on the intended and actual use of resources and to be made responsible for it. Accountability requires appropriate systems of checks and balances as well as sanction mechanisms allowing to hold decision-makers responsible for their actions.

The precondition for ensuring accountability is transparency of public finances without which politics and administration cannot be controlled. In turn transparency is only possible if information is available and used in public. Good Financial Governance therefore requires the cooperation of various players and control bodies, including Parliament, civil society and the media, using the available information to control public financial conduct (see box 1).

Most important in compiling information on political priorities and resources allocated is the budget, although not all the government's policy decisions imply public expenditure – and thus are relevant to the budget. The budget needs to be comprehensive. The more government activities are carried out off-budget, the weaker is transparency, and thus correspondingly fewer are control options and the greater is the potential for corruption.

Accountability further requires an independent control system and an independent legal system for the public which ensure that relevant rulings are applied and observed and that non-compliance is sanctioned.

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<sup>6</sup> There are reports of the draconic tax collection from some countries, i.e. surprise visits by tax officials who haven taken the shop till with them, as in Uzbekistan, or violent acts by district officials as have occurred in Tanzania.

<sup>7</sup> UNDP (2001), page 2

**Rule of law** requires that all state actions are carried out within a fair and impartial legal framework. At the same time, it means that this legal framework is protected by the state itself. Rule of law guarantees the recognition of human rights. The division of powers with independent legal institutions is crucial for the rule of law.

Rule of law in terms of Good Financial Governance creates predictability and trust in public finance. All public financial management activities must be based on laws that have been passed through democratic processes. The budget itself must have the status of law. Its proper implementation must be audited independently and audit reports must be submitted to Parliament.

The **performance** principle means that the state is willing and able to provide public goods and services that meet citizens needs, making the best possible use of resources, i.e. they should be provided effectively and efficiently applying the principles of Good Governance.

Improving the performance of public institutions in terms of public financial policy and management has increasingly become a development cooperation issue in recent years. Interventions, however, are often very technical in nature and emphasis is put on the introduction of technical procedures and information systems. Even though, in many countries, the public financial management has alarming technical shortcomings, improving performance must be viewed as part of the systemic process of capacity development, involving both personnel and organisational development alongside technical (information) systems.

Crucially, opportunities for capacity development are based on willingness and commitment of political decision-makers, on their motivation and leadership. This is particularly difficult in the case of public financial management reforms as they impact on rent-seeking possibilities within the entire system. Hence strong institutions are key to ensuring that reforms are directed towards Good Financial Governance. The need for capacity development is not confined to finance administrations – finance ministries, revenue administration and supervisory authorities; all institutions administering public funds must be equal to the task.

In general, **development orientation of government** means, that the government is seeking to provide a socially balanced policy structure, as well as economically and ecologically sustainable development.

For Good Financial Governance development orientation of the government focuses on the mechanisms that are most relevant for transforming sound public finance into benefits for the population, in particular the poor. This means especially the effective and efficient delivery of development relevant goods and services, the facilitation of fair participation in political and economical resources for all citizens and the assuring of sound macroeconomic framework.

**Box 1: Challenges in tackling corruption in Kenya**

- Maintaining political will
- Revival/migration of corrupt networks
- Institutional co-ordination and capacity
- Resistance to change/ to Civil Service Reforms
- Sustainability of reforms – lack of progress on institutional change and prevention mechanisms
- Political reforms slip down coalition agenda
- Competition for scarce resources
- “Governance dividend” not apparent

*Gladwell Otieno  
(GTZ – Eschborn Dialogue 2004, Workshop on Good Financial Governance, June 2004)*

Macroeconomic stability requires sound planning systems in the budget cycle, preferably in a medium term framework, as well as effective control of expenditure management.

**In conclusion, it can be said** that the Good Financial Governance approach has an immediate impact on the power structures and areas of responsibility in a country. Reforms of public finance based on Good Financial Governance aim at redistributing power between state structures, creating a better balance of power between state and citizens (transparency and accountability) and a better balance of power and resources between different groups (reduction of poverty and fair taxation). Taxation that is unfair and distorted, an incoherent and inconsistent state budget, weak financial control and the redistribution of public funds between and within local authorities<sup>8</sup> are crucial challenges for the development of a country. In recognition of this fact, interest in public financial policy and management in developing and transforming countries has increased significantly in the past decade.

## **2.2 Rising interest in public finance within the development policy debate**

The significance of Good Governance in the area of public financial policy and management was already underlined by the HIPC initiative and further by the Monterrey Consensus. Development needs sound financing and responsible use of public resources –be they own revenues or donor funds. In the Monterrey Consensus developing and donor countries agreed to extend their cooperation in this area.

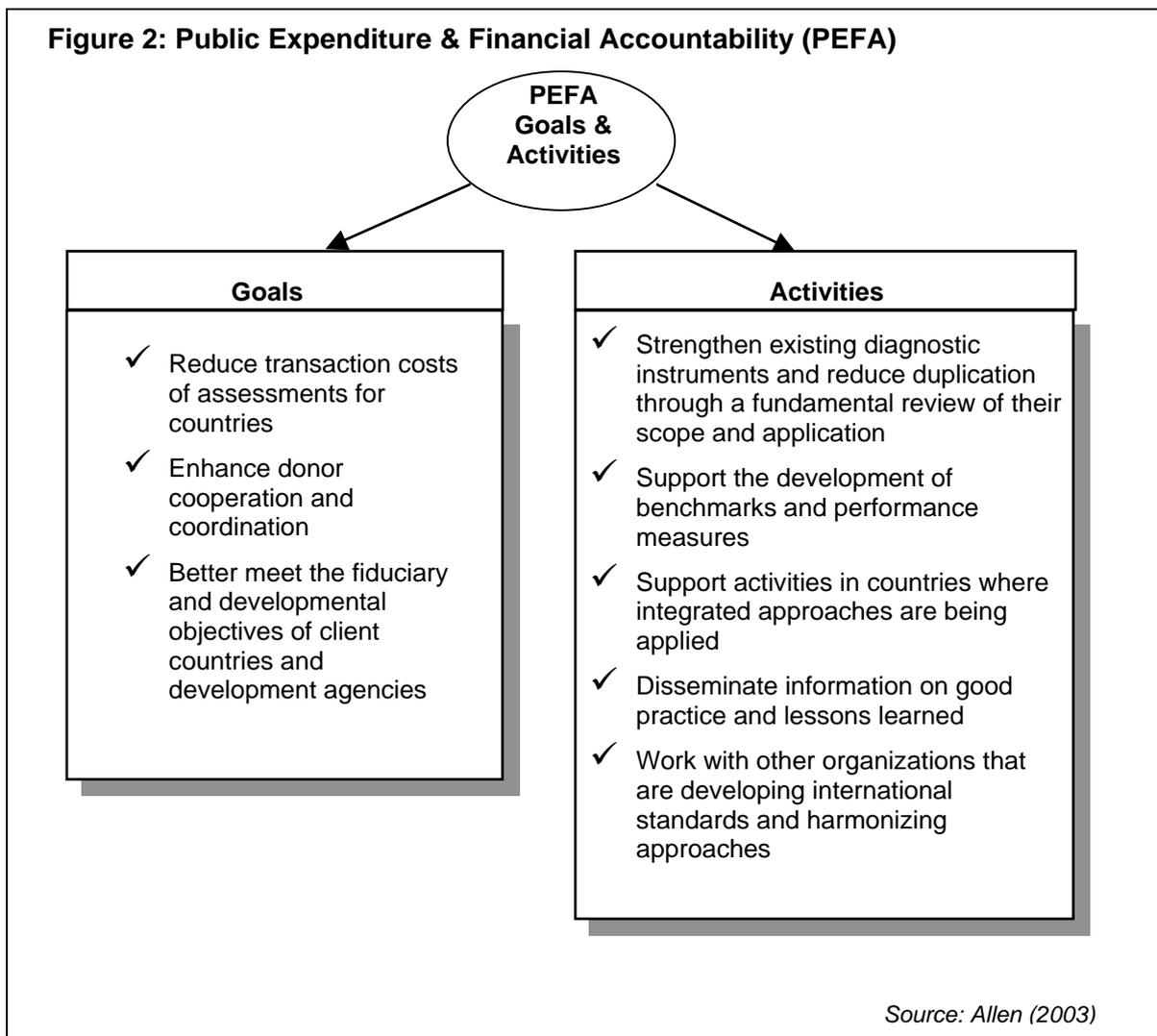
In addition more emphasis has been placed on the significance of Good Governance in the public finance sector due to the fact that the donors seek to align their contributions to partner countries' systems, in form of programme-based approaches and their joint financing. Donors require partner countries to create a sound basis for public finance and make the structures and processes more comprehensible. Only this way can fiduciary risks be significantly reduced, which is a precondition for moving from project orientation towards new forms of development cooperation<sup>9</sup>. In discussions alongside the implementation of the Paris Agenda, it has become increasingly obvious that partner countries are not only accountable to donors concerning the use of donor funds, but also – and especially – accountable to their own citizens concerning all funds that have been used (domestic accountability).

As a consequence public financial systems have become the focal point of international discussion as never before:

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<sup>8</sup> Vertical and horizontal financial equalisation

<sup>9</sup> Programme orientation, SWAPs (Sector Wide Approaches), budget aid, basket funding etc .



- World Bank and the IMF have intensified their cooperation in the field of public finance. Since 2000 they have, for instance, jointly drafted Joint Staff Agreements relating to the PRSP processes of the respective countries<sup>10</sup> which also contain estimates concerning the public financial system. The HIPC Accountability Action Plans (AAPs) demand far reaching reforms in budget drafting, reporting as well as the introduction of integrated financial administration systems.
- World Bank, EU and bilateral donors have developed Expenditure and Financial and applied a large number of diagnostic tools for the evaluation of public financial management<sup>11</sup>. Between 2001 and 2003 the number of CFAAs, CPARs and PERs doubled from 40 to 80 per year and expenditure rose from US\$4.4 million to \$22 million per year<sup>12</sup>. In addition country analyses are now publicly available in many cases<sup>13</sup>. With the Public Expenditure and Financial Accountability (PEFA) programme (see figure 2),

<sup>10</sup> See ODI (2004)

<sup>11</sup> The most important instruments are the CFAA (Country Financial Accountability Assessment), the CPAR (Country Procurement Assessment Report) and the PER (Public Expenditure Review).

<sup>12</sup> Dorotinsky (2004), page 4

<sup>13</sup> e.g. at [www.countryanalyticwork.net](http://www.countryanalyticwork.net)

donors jointly developed a diagnostic framework, which facilitates the elaboration of joint assessments.<sup>14</sup>

- Also the DAC has agreed on a joint position to strengthen public finance in partner countries<sup>15</sup>. The policy agreed involves supporting countries' own reform programmes coordinated with aid programmes lasting several years and to jointly develop monitoring systems for the follow-up of results.
- IMF and World Bank have developed minimum criteria for budget planning, implementation and reporting. Surveys of the implementation of the HIPC AAPs in 2002 and 2005 identified considerable weaknesses throughout the whole budget process. Improvements were found in only two countries between 2002 and 2005; five countries are seen as having "certain" additional reform requirements and 16 require substantial reforms<sup>16</sup>.
- Finally the inclusion of the fight against corruption as 10<sup>th</sup> principle of the United Nations Global Compact in 2004 underlines the significance of public financial management for creating more transparency and compliance with the law at the interface between the public and private sector – above all concerning policies, and in the tax and customs administration.

In summary these developments result in a transfer of the ownership of reform and development processes to the governments of the partner countries, as was agreed in the Declaration of Paris. Moreover there is broad consensus that systems and capacities in the public sector are mostly far away from international standards and need substantial strengthening and Therefore in most countries that receive debt relief or general budget support reforms in public budgeting form part of the policy dialogue: "The improvement of Public Finance Management is a top priority of the budget support approach," postulates the EU.<sup>17</sup> The institutional reform processes necessary for sustainable management of public finance are politically sensitive and time consuming and can therefore only be achieved in the long term. Since Good Financial Governance touches the essential functions of government, it cannot be created from outside: it needs ownership and responsibility of all stakeholders, including government and society.

### **2.3 Stakeholders in Good Financial Governance**

All individuals and government units that have the function of regulating, organising and controlling the use of public resources are involved in the implementation of Good Financial Governance (see figure 3).

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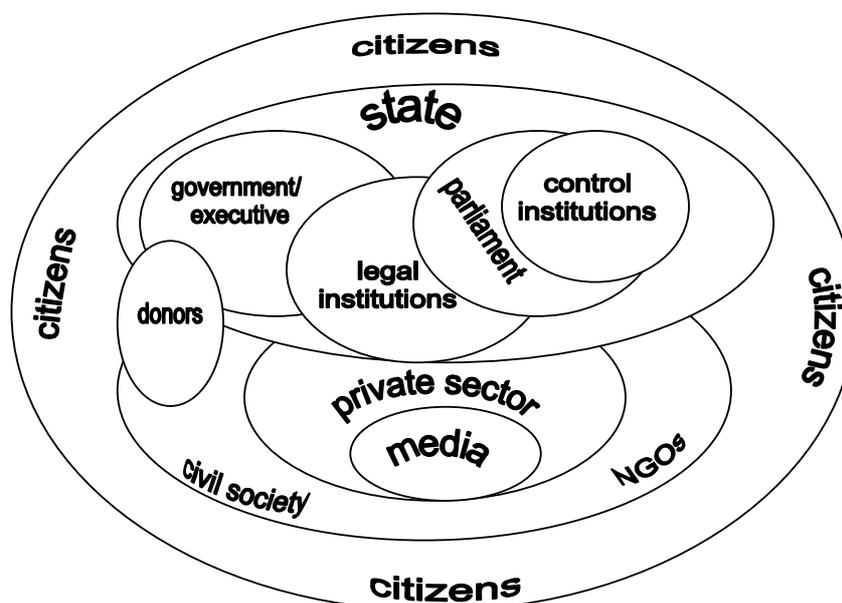
<sup>14</sup> Compare [www.pefa.org](http://www.pefa.org) . The "Performance Measurement Framework" was intended to replace the large number of diagnostic tools.

<sup>15</sup> DAC (2004b)

<sup>16</sup> IMF/ World Bank (2005), page 3

<sup>17</sup> EU (2004), page 1

**Figure 3: Stakeholders in Financial Governance**



Source: Based on Graham/Amos/Plimtree (2003), p. 11

The main parties involved in this process are **government institutions**, which are responsible for the administration and control of public revenue and expenditure, the **Ministry of Finance** being assigned the main role as the leading administrator of this procedure. The precise tasks of the Ministry of Finance vary greatly between countries and forms of government. In some countries investment and development planning, for instance, is drafted separately by a planning ministry, in other countries it is integrated within the Ministry of Finance. Sometimes budget reporting and cash management is done by an external treasury, in other cases this treasury is a department of the Ministry of Finance itself. All the organisational forms have advantages and shortcomings, but core functions of Ministries of Finance are clearly identifiable (see box 2).

The Ministry of Finance plays the central role formulating and implementing a country's financial and economic policy, which often leads to conflicts with **line ministries** and other **spending agencies**, responsible for implementing government policy in their sector. Some of these conflicts are unavoidable<sup>18</sup>, e.g. if the Ministry of Finance reduces funding because an unforeseen cash shortage, or if a change in policy leads to a

**Box 2: Core functions of the Ministry of Finance**

- Setting fiscal policy
- Forecasting revenues
- Managing the budget process
- Managing resources, including bank accounts
- Supervising of accounting procedures and financial regulations and control of compliance
- Monitoring of compliance with resource restrictions.
- Preparing the annual financial statements of government and other regular financial reports
- Managing external resources

*World Bank (2005), Main players S. 1*

<sup>18</sup> World Bank (2005), Main players page 5

reallocation of funding between sectors, so that authorities receive less funding than had originally been planned. Such disputes then require a regulated negotiation process, managed by the Ministry of Finance. Avoidable problems often arise due to capacity constraints within the Ministry of Finance or the line ministries themselves, e.g. due to faulty analysis and incorrect forecasts or management problems throughout the budget implementation process. Because of its' close financial interrelations with all the spending departments, shortcomings in the Ministry of Finance are felt right across the entire government sector and can thus impede proper implementation of sector-specific policies.

The **revenue administration** is responsible for the procurement of state resources by collecting taxes, duties and levies. Its significance for Good Financial Governance is obvious - it creates the basis of government financing. Once again there are various organisational models. In many countries there is a unique centralised revenue administration at central government level. Others have delegated and/ or decentralised powers to provinces, districts and local authorities. A certain degree of fiscal decentralisation necessary for economic efficiency, but complete decentralisation of revenue collection in most developing countries is hardly feasible and probably not desirable either.

Besides the fiscal role, revenue administrations have an important democratic function because they are in very close contact with the citizens. The burden of the state is felt heavily by tax payers when they pay their taxes. Some tax contribution – even very small – is thus important to raise the citizens interest in what their money is used for; taxation creates a basic incentive for democratic participation. Further, the way revenue administrations act in tax collection shapes the citizens' perception of the state. Transparent, uncomplicated tax collection based on the rule of law contributes to the willingness of citizens to participate in political and public life and reduces tax evasion. Contrarily taxation that is felt unjust or difficult to comply with leads to evasion and undermines trust in governmental actions.

Good Financial Governance further requires **financial control institutions** working together in a system of checks and balances. Control is often understood exclusively as external control by an independent supreme audit institution (SAI). Yet the SAI is only one part of the system and can achieve little if records are not created and kept properly and accounting regulation is not applied within the administration.

In addition, a form of **financial jurisdiction** that ensures the legal background for public financial policy and management, guarantees the rule of law, makes state institutions that abuse public money legally accountable, and protects the citizens' rights in relation to the government, is crucial for the implementation of Good Financial Governance.

**Parliament** is responsible for the decision on the legal framework, and for political decision making and control in the budget process. In many countries parliaments – including the financial and/or budget committees are of weak capacity, provided with little resources and badly informed. They are often not able

**Box 3: The challenge for Parliament**

- It is critical that Parliament takes the driver's seat on the allocation and management of public resources and ensures that the deployment of resources is consistent with, and conducive to, the economic welfare of Kenyans.
- Parliament needs to draw a line between political differences and the welfare of taxpayers, who pay their salaries.

*Gladwell Otieno  
(GTZ – Eschborn Dialogue 2004, Workshop on Good Financial Governance, June 2004)*

to discuss and control governmental budgets or auditing reports. Little parliamentary control contributes to a high level of corruption within public administration. Hence government and administration have little interest in improving the role of parliament in GFG.

Although **donors** are external players for the recipient countries, they play an important role in achieving good financial governance. They provide important financial resources; in many African countries they finance the largest fraction of the investment budget. The way how donors organize their contribution is therefore essential to the regularity and predictability of funding for public investment in many countries. In addition donors offer important assistance in building the capacity of the various players in Good Financial Governance. For example, the level of cooperation with parliaments has up to now been comparatively low, whilst strengthening civil society, through the development of NGOs and latterly through the participation requirements in the formulation of PRSP, has proved to be effective in many countries.

**Civil society** is a central player in the quest to achieve good financial governance. In the absence of any public interest there is no need for the government to answer to the citizens. Without public interest and request there is no need for enhancing accountability. Direct participation of civil society in budget formulation has increased in many developing countries in recent years through the requirements for participation during the formulation of PRSP. In most countries the principal mechanisms for direct participation are limited to community or district budgets. With good reasons – participation implies cost of decision making which have to be balanced with the needs for effective and efficient delivery of results.

In the majority of developing countries, civil society is still weak. Checks and balances through pressure and interest groups are often much less important than personal relationships in patrimonial systems. The media landscape is often small and not very critical. Under these circumstances alternative, participatory forms of involvement have to compensate for this shortcoming. Non governmental organizations (NGO) have come to represent especially the interest of the poor which have very little voice in political systems.

In general actions and interactions of the players involved in Good Financial Governance are interrelated and characterised by the **cultural conditions** in the country. Cultures of administrations, for instance, follow formal and informal structures, which in the majority of developing countries still bear the stamp of the administrative traditions of the former colonial powers. The structure of the tax system has an influence on taxpayers' sense of justice and willingness to pay<sup>19</sup>. The way in which the public controls the government depends amongst other things on the moral concepts in society, e.g. to what extent public criticism is socially acceptable in the first place. These few examples demonstrate that there are no standardised solutions on the road to good financial governance, and this is also one of the most important lessons for the structuring of reform processes<sup>20</sup>.

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<sup>19</sup> BMZ/GTZ (2006)

<sup>20</sup> See in detail DAC with respect to this (2005), paragraph 38f.

### 3. Aiming at Good Financial Governance: Challenges and perspectives

In the last chapter, the Good Financial Governance approach was developed and related to development policy and cooperation. Now in the following chapter we elaborate requirements for public finance reforms – on the revenue and expenditure sides of the budget and also in terms of its control – from the perspective of Good Financial Governance. For each topic the respective problems and workable solutions will be shown. Aiming at Good Financial Governance it is not only the content of the reforms that is essential, but above all the structuring of the reform processes themselves. Therefore, the descriptions are preceded by a section on the organisation of the reform processes, summarising the findings from the point of view of IMF and OECD<sup>21</sup>.

#### 3.1 Timing and sequencing of reform processes

The overview of stakeholders in Good Financial Governance showed that reforms aimed at improving financial governance concern many players and are therefore complex and difficult to organise. It is thus important to plan for an appropriate **period of time** for reforms. Reforms in the field of public finance cannot be achieved in the short term; they are a medium-term to long-term process. How they are organised is critically affected by a country's capacity and political willingness to reform.

There are **three main areas of intervention** in reforming public finance: the revenue system (i.e. the revenue administration and policy), the system of expenditure planning and management, and the control system. In most developing countries there is an urging need for reform in all these areas. Experience with fiscal adjustment shows that in general in all countries expenditure-based adjustment appears more durable for reaching fiscal consolidation than revenue-based adjustment. Revenue-based consolidation carries a higher risk of reversal in industrialized countries; they seem relatively more sustainable in emerging markets or developing countries.

Experiences with technical cooperation to public finance reforms in the past suggest some **guidelines for the structuring of advice**:

- Advice must be adapted to the conditions in the partner country – “**No One Size Fits All**” (NOSFA principle).

The significance of cultural conditions for the structuring of reform processes has already been addressed (see section 2.3). Reference should be made at this point to the recent discussion concerning capacity development, which has helped to gain broader consensus for the conclusion that capacity development cannot be reduced to the transfer of organisational models but must always be based on the specific country situation. The Declaration of Paris also views capacity development as a necessary, endogenous development process and gives donors an advisory role, whilst the government bears responsibility for the process<sup>22</sup>.

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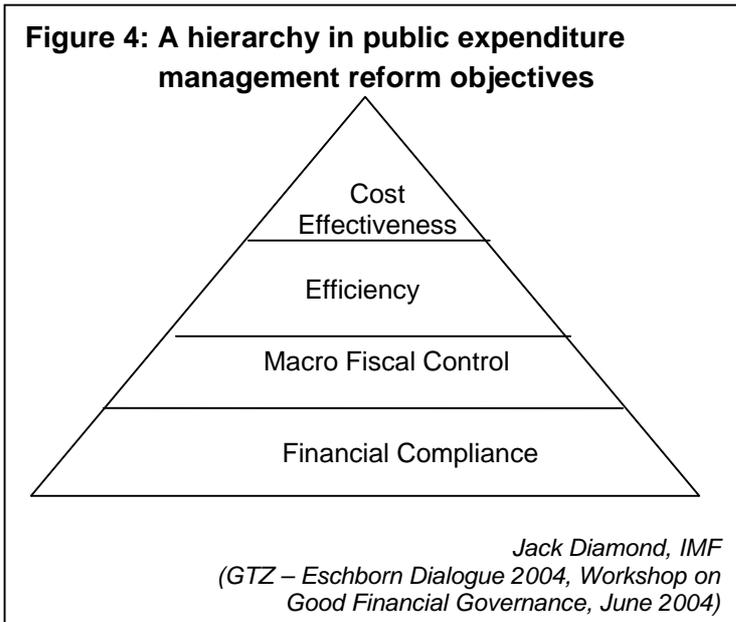
<sup>21</sup> The chapter summarises the presentations by Jack Diamond (IMF) and Alex Matheson (OECD) at the Workshop on Good Financial Governance, during the GTZ Eschborn Dialogue in June 2004 .

<sup>22</sup> Declaration of Paris (2005), paragraph 7, 19f. and 25 (Public Financial Management)

In its recently completed evaluation of capacity development in Africa, the World Bank found that public financial management reform programmes encountered major problems precisely if they attempted to introduce unfamiliar, and complex technical solutions which were highly dependent on outside advice<sup>23</sup>.

- The **prioritisation and timing** of the assistance are important – some issues need to be dealt with before others.

Interventions depend on the extent of existing problems and the capacity available to solve them. With limited capacity available, a hierarchy of reform objectives must be followed (see figure 4). The first goal should be to restore financial compliance, i.e.



countries with fundamental *governance* problems should first ensure fulfilment of the law. Countries with macroeconomic instability must additionally ensure that they control the aggregate fiscal variables. Macroeconomic instability reduces the government's ability to act to such an extent that other policy objectives can no longer be achieved. Countries which have the rule of law and macroeconomic stability can focus on increasing the efficiency and effectiveness of their public financial management system.

- **Reforms must be organised in sequence** – recognising the limited capacity for the implementation of reforms, not everything can be done at once.

Institutional improvements have proved to be key elements in consolidating fiscal policy. An important precondition to this end, however, is a stable and professional public administration. Planned reform processes are frequently too ambitious for the country's existing capacities. In countries with sufficient capacities, several reforms can be organised in parallel. Reforms should be adopted in sequence when countries do not have sufficiently robust capacities.

- **Process structuring** is extremely important – reforms do not just happen, they must be engineered.

It is crucial that reforms are understood as being essential institutional changes, requiring clearly delineated areas of responsibility and a corresponding form of **change management**. Even donors who demand reforms of the public financial system frequently concentrate too much on mere technical implementation. On the partner's side, political support is often present, but the need to change processes and modes of

<sup>23</sup> World Bank (2005), pages XV and 29f .

behaviour is only hesitantly recognised within the administration. In this process it is necessary to identify “change agents” – people who can drive change.

Experience with public financial policy and management reforms in recent years teach us that **political participation and pressure of civil society** are crucial factors in the adoption and continuity of reform processes. In Kenya, for instance, the public vigilance contributed to the exposure of scandals in the procurement system. Public demand for Good Governance in Uganda also had a greater effect than the same demand from donors (see box 4).

**Box 4 : Good Financial Governance – the role of transparency and participation**

- “The public outcry for good *Governance* outweighed the demand of donors.”  
(Florence Kuteesa, Uganda)
- “More access to information allows a civil society to demand *Accountability* from their government [and is, therefore, crucial to fight corruption].”  
(Gladwell Otieno, Kenya)
- Speaking of stakeholders in the budgetary process:  
“Positive and productive participation is the challenge.”  
(Florence Kuteesa, Uganda)
- “If recent procurement scandal exposes are true, then tens of billions of shillings could have been lost by the government were it not for the vigilance of watchdogs, parliamentarians and the media.”

*GTZ – Eschborn Dialogue 2004, Workshop on Good Financial Governance, June 2004*

### 3.2 Challenges and reform needs on the revenue side

Good Financial Governance on the revenue side means that public funds – be they external and/or government’s own - are predictable and regularly sufficient to cover planned expenditure. It means that funds are raised whilst taking account of taxpayers’ ability to pay, that the revenue administration works in accordance with the rule of law and is accountable to the public and is able to perform its task. To achieve this state of affairs all institutions involved – parliament, government (above all the Ministry of Finance), the revenue administration and the judiciary – must cooperate with one another. This applies all the more so due to the fact that citizens watch the growth of their personal tax burden particularly closely.

**Revenues** in the majority of developing countries are made up, to a considerable extent, of external revenues as well as their own revenues. Successes in public expenditure reforms that lead to enhanced budget planning systems and increased transparency in public budgets more and more show the real dimensions of **donor financing** in many developing countries. Those reform programmes usually require – among other – the inclusion of all donor contributions into the budgets and often, in consequence, the share of donor financing increases mainly in the investment budget. The predictability of donor funding as an important element of orderly budget implementation in partner countries thus becomes obvious. In reality, flows of donor funds are considerably more volatile and less reliable than the recipient countries’ own revenues<sup>24</sup>. The predictability of donor resources is therefore a fundamental component of Good Financial Governance.

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<sup>24</sup> An IMF study, for 33 countries in which more than 50% of public expenditure is funded by donors, found that the volatility of development aid funding was seven times higher than that of the governments’ own revenue. In addition one also has to take account of the fact that funds committed are generally higher than funds disbursed (see DAC (2004), page 8).

The situation is aggravated for many countries by **shrinking customs revenues**: tariffs are reduced due to the insight that they distort trade and the price system or simply due to regional integration (e.g. SADC in South Africa) while for some reason the volume of trade does not increase enough to compensate the loss. This raises the question of sustainability: To what extent countries will be able to cover investment in the development process by own revenues in the future?

Notwithstanding the emphasis the Monterrey Consensus put on **strengthening the self-financing capacities of developing countries**, the establishment of sustainable operating revenue systems does not stand very much in the focus of public finance reforms – neither from donors' nor often from the respective country's side. Among the PEFA-instruments revenue analysis and enforcement of the self financing ability of developing countries keeps a very low profile. The PRSP-sourcebook, although very practical in the contributions to public expenditure management, mentions revenue management only under technical aspects in the annex. The ability of countries in collecting taxes is hardly ever included in the policy dialogue attached to joint donor financing mechanisms and they are hardly ever mentioned in the policy matrices of World Bank PRSCs.

Interestingly, therefore, ownership of reforms to increase revenue among partner countries is much stronger than is the case of reforms on the expenditure side. Donors usually find that the effort to self financing in developing countries is low. And indeed, there is some statistical evidence in favor of that view<sup>25</sup>: The tax to GDP ratio in most African countries does not exceed 20%; in OECD countries it amounts to an average of 35%. In some African countries - as Tanzania and Uganda - the figure is as low as 12%. This has not been changed by the broadening of the tax base through the introduction of value added tax (VAT). During the last fifteen years, the number of countries raising the VAT has increased from 2 to 30 in Africa.<sup>26</sup> All over the world the VAT is the most important tax, covering in 120 countries a quarter of all taxes raised.

However, many developing countries have very limited possibilities of increasing their own revenue levels. **Broadening the tax base** will not solve the problem in countries with very low monetary income per capita. Extending taxation to the informal sector as, for example, desired in a number of countries, is questionable in terms of the administrative burden and will not deliver any significant amounts if designed according to poverty reduction objectives, i.e. exempting minimum income from taxation. The tax to GDP ratio depends on a country's degree of industrialisation. Tax revenue will only increase if the economic structure allows a broad tax base<sup>27</sup>. In this respect a pro-poor growth policy also always makes a contribution to the country's own sustained revenue generation.

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<sup>25</sup> Compare this and Fjeldstad (2004), page below.

<sup>26</sup> Ebrill et al. (2002), page 2

<sup>27</sup> See Fjeldstad (2004)

**Box 5: Quantitative Results on the Relation between Revenue Mobilisation and Corruption**

- Higher corruption reduces tax revenue.
- Corruption reduces revenue from social security tax the most; next, it reduces sales taxes; and last it reduces personal income taxes.
- A one point increase in the corruption index reduces tax revenue by 2.7 percent of GDP.
- Corruption increases tax evasion.

*Source: Tanzi (1999), page 7*

But even if incomes are low and the tax base limited, usually there are many ways to improve. The consequence of a small tax base is to concentrate reform efforts **on streamlining tax collection in the areas where it is most productive**: through reducing generous tax exemptions, enhancing effectiveness of the revenue administration, through reducing tax evasion and corruption. Corruption is closely related to the share of tax revenue in GDP (see Box 5). Reforms of tax policy and tax administration are closely related in terms of the results of the taxation measures. Taxes based on written laws and not requiring frequent contacts between taxpayers and tax administrations are much less likely to lead to acts of corruption by tax administrators. The revenue policy and administration should be organized to minimize incentives and possibilities for irregularities<sup>28</sup>.

If the tax base is narrow, the **revenue administration must develop special strategies**. In many countries, from 60% to over 80% of revenues come from a small proportion of taxpayers (see box 6). It is therefore sensible to concentrate the administration by setting up large taxpayer departments as a first step. There the administration is not broken down in terms of the type of taxes and tax functions but based on the taxpayers' personal file. What already is common practice in most Latin American and Asian countries has started to be introduced also in African countries in recent years. In highly donor dependent countries this approach reveals heavy consequences of lacking donor harmonization: If IT systems for VAT, income tax and customs duties are not technically compatible with one another because they were developed with the support of different donors, then they are only of limited use in large taxpayer departments. Moreover, the setting up of large taxpayer departments should not lead to a situation whereby the regular tax administration is divorced from the reform process. In the long term it is vital that large sections of the population are integrated within the taxation process. Only then does the tax-paying public have an interest in demanding accountability from govern-

**Box 6 : Tax policy Issues for Developing Countries and Countries in Transition –Lessons to Learn**

- Start with large enterprises (70 % of revenue)
- Get the total picture of them (structure, policy, risks etc.)
- Understand international trends
- More attention to execution (auditing, collection and client communication),
- Start a tax academy (develop skills, corporate identity, practical study cases, certification)
- Human resource management policy (personal development, support by management, teambuilding, remuneration policy, study visits etc.)

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(GTZ – Eschborn Dialogue 2004, Workshop on  
Good Financial Governance, June 2004)*

<sup>28</sup> See Tanzi (1999), page 4

ment about the use of tax revenues. For this reason a strategy should be developed at an early stage in the reform of the tax administration for extending the positive effects of reformed large taxpayer departments to the entire revenue administration.

In recent years, **(semi) autonomous revenue authorities** have been created in many developing countries<sup>29</sup>. The independence of these authorities allows reforms of the tax administration even when a general reform of the civil service is not progressing. Experiences to date have been inconclusive: some countries were initially able to increase their revenues considerably and combat corruption to an impressive degree, but it was apparently not possible to sustain the results<sup>30</sup>.

These are all technical solutions to improve the respective country's own revenue and are necessary but not sufficient on their own. The country's own revenue cannot be secured sustainable without the **support of the population**. Legality, the rule of law and accountability are core elements in ensuring greater tax compliance. Empirical studies have revealed that tax evasion is less pronounced in cultures that have, and permit, more political participation than in forms of society which do not promote participation to the same extent. Even in subcultures there are different degrees of tax compliance despite the same tax jurisdiction and administration.

A key challenge on the **revenue side** from the donor's point of view has become apparent in the context of the **general budget support** discussion. Donor funding cannot replace the country's own revenue in the long term and, within the budget support, a large proportion of funding will continue to be provided in the form of loans, which constitute liabilities that partner countries have to repay. The challenge consists in developing appropriate donor exit strategies as part of general budget support instruments, in which strengthening of the country's own revenue side must play an important part. Only in this way can sustainability be guaranteed so that the structures created through joint financing remains in place and partner countries do not fall back into the debt trap.

<p><b>Summary:      Need for intervention on the revenue side to ensure Good Financial Governance</b></p> <ul style="list-style-type: none"><li>■ Stabilisation of external revenue through greater predictability of donor funds.</li><li>■ Increasing own revenue through:<ul style="list-style-type: none"><li>● Feasible tax reforms in the context of the country, administratively friendly tax legislation, broadening of the tax base, primarily by abolishing exemptions and promoting growth.</li><li>● Improving the tax administration by concentrating on important tax sources, capacity development, strengthening of technical systems</li><li>● Consideration of the tax culture, improving political participation</li></ul></li><li>■ Consideration of the country's own revenues when formulating donor exit strategies in the context of budget support</li></ul>
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### 3.3 Challenges and reform needs on the expenditure side

Good Financial Governance on the expenditure side requires regulation-based, effective planning and implementation of public expenditure in accordance with political priorities

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<sup>29</sup> (Semi-)Autonomous Revenue Authorities, see USAUD concerning this (2004).

<sup>30</sup> Above all, because the higher wages paid in the Revenue Authorities do not permanently compensate for the lost profits from corrupt behaviour, and corrupt networks quickly re-establish themselves after some initial success, see Fjeldstad concerning this (2004), page 3.

which reflect citizens' preferences and requirements, e.g. in line with a development strategy created in consultation with the public.

In development cooperation, donor interventions focus much more on public expenditure systems and budget planning than the revenue side<sup>31</sup>. The main reason for this is that ownership implies responsibility for funds, including donor contributions to the budget. This responsibility can only be transferred to governments if the public financial system ensures an adequate handling of funds. Introducing reforms in the field of public expenditure administration is a long and complex process. The focus usually lies on improving transparency in budget planning, and then the performance of the institutions involved.

Ideally the **budget cycle** comprises the following steps (see figure 5 below). It starts with the government and the executive, which prepare budget proposals based on macroeconomic forecasts concerning available resources as well as the expenditure plans of the line ministries (steps 1 to 5). Cabinet and Parliament discuss and approve the budget (steps 6 and 7). The Ministry of Finance releases the funding during budget execution through the line ministries and these manage the account records to which the expenditure is booked (step 8). The annual financial statements of the line ministries are ultimately prepared by the Ministry of Finance (step 9). The consolidated financial statements are audited by an independent control authority, normally the Supreme Audit Institution (step 10). Parliament ultimately approves the audited financial statements (step 11).

In reality there is plenty of scope for improvement within this entire process. In **budget planning**, most critical are the stipulation of spending limits as well as the comprehensiveness of the budget. In many developing countries the actual dimensions of the budget are unknown because a large portion of financial resources are not contained within the budget. There are numerous parallel and special budgets, which prevent a comprehensive budget: the incomplete documentation of development aid has already been mentioned, revenues from extractive industries are frequently not completely recorded and in the military sector there are repeated examples of revenues and expenditure that are not entered in the books. In this respect it should also be mentioned that project funding has to this day frequently been carried in the parallel budgets of the line ministries by project management units (PMUs). What was initially conceived as a solution to insufficient capacity on the partner side became part of the problem. Large parts of investment funding are not administered by the Ministry of Finance. This not only undermines the comprehensiveness of the budget but also weakens the Ministry of Finance in institutional terms.

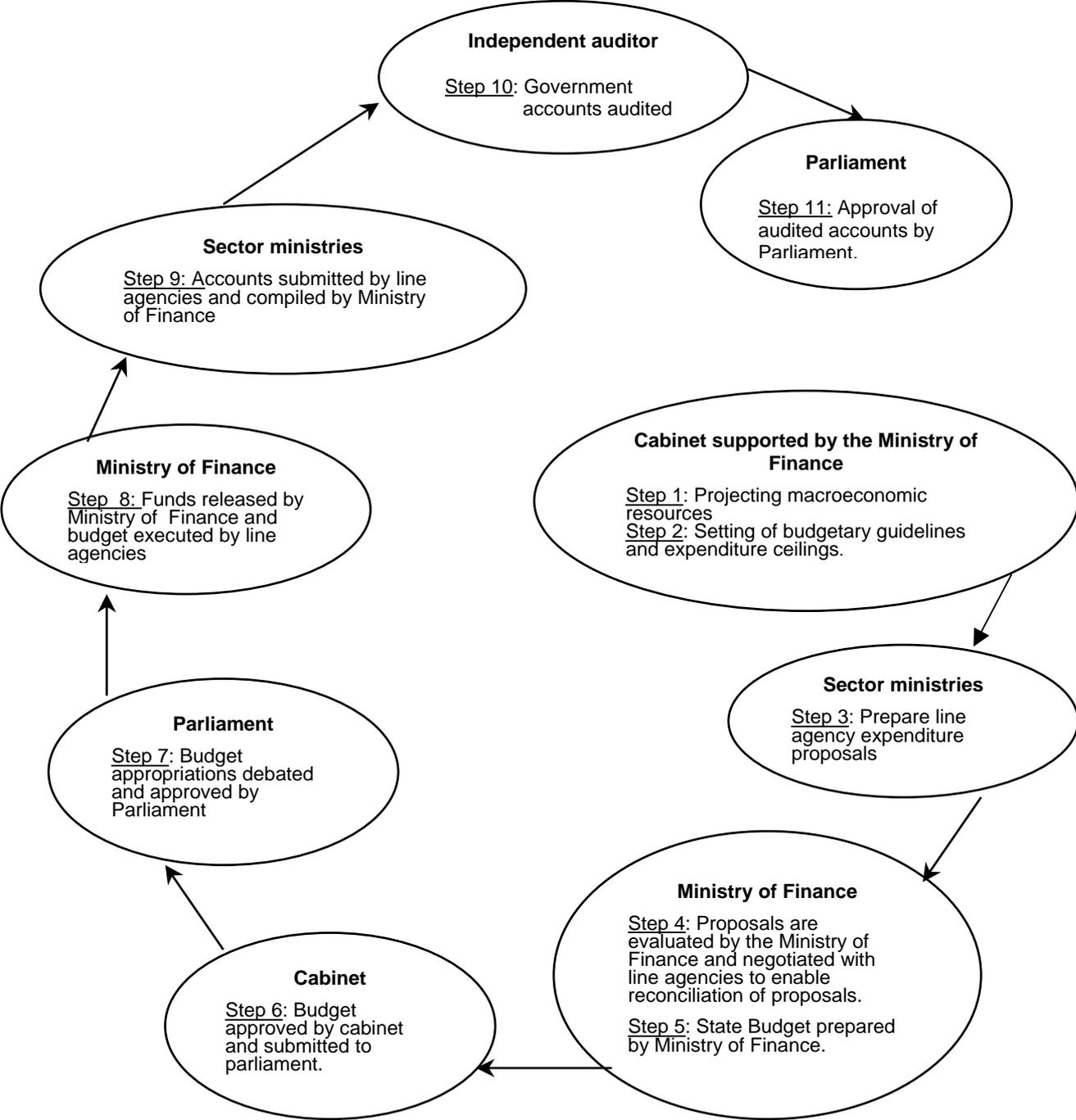
The **feasibility of spending ceilings** is decisive in terms of the credibility of a budget. If, as is the case in many countries' budgets, ceilings are constantly adapted throughout the budget year, the budget loses its function as a comprehensive management instrument for public expenditure. Two factors predominantly determine the extent to which a budget is realistic in developing countries:<sup>32</sup>

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<sup>31</sup> Even the EFTA-Workshop 2004, which is the basis of this paper, was called, despite valuable contributions from Odd-Helge Fjeldstad and Victor van Kommer - "Good Financial Governance : How to Ensure the Accountable Use of Public Funds ."

<sup>32</sup> In addition there are a whole series of political economy reasons why public financial planning is so markedly divorced from reality, which apply equally to industrialised nations. However, in industrialised countries those reasons tend to produce excessive expenditure plans.

**Figure 5: The budget cycle**



Source: PRSP-Sourcebook, Chapter 6, page 192

- Firstly, a realisable budget can only be prepared based on accurate growth and revenue forecasts.<sup>33</sup> These forecasts are frequently invalid after just a few months due to volatile inflation rates and currency exchange rates. Consequently unscheduled and expensive short-term loans have to be taken out, tying up resources that were intended for other purposes. The actual costs of borrowing are therefore easily underestimated. Macroeconomic stability is thus an essential requirement for reliable budget planning. Donors can support budget planning by on time disbursement of committed funds.
- Secondly, line ministries are often not capable of planning their funding requirements appropriately even if the available resources have been correctly forecast. Frequently they are not even asked what their requirements are during expenditure planning, but only receive the spending ceiling per institution, set by Cabinet. Correct medium-term cost estimates would improve the appropriateness of the expenditure framework. In practice, however, inadequate capacity leads to rather unreliable results. Expenditure projections are often based on updated past values, which were also already inappropriate, than extrapolated to unrealistic price adjustments. This demonstrates how important capacity development of the institutions administering funds is for budget planning (and not just budget implementation).

These shortcomings in budget planning have led to a situation whereby donors increasingly demand the introduction of medium term financial planning, generally in the form of **Medium**

**Term Expenditure Frameworks**

(MTEF). MTEFs should not just update current plans, but also record the long-term implications of ongoing expenditure and provide the foundations for matching future financial requirements with forecast financial resources<sup>34</sup>. This has become especially important for the implementation of poverty reduction strategies, which need constant long-term public investment. Some form of medium-term financial planning is therefore essential to ensure reliable budget planning. However, the debate among donors concerning reform of public financial systems in developing countries also gives rise to ideas that make excessive demands on the efficiency of local administrations.

**Box 7: Paradigm Shift in Budgeting**

<b>Old paradigms</b> <i>'Conventional budgeting'</i>	<b>New paradigms</b> <i>'Public Expenditure Management'</i>
Budget cycle	Budget policies and institutions
Rules	Incentives
Inputs	⇒ Outputs/outcomes
Compliance	Performance
Centralised control	Decentralised responsibility
Bureaucratic opaqueness	Transparency and accountability

*Source: ODI (2004), page 1*

The public expenditure debate has shifted within the past years from “conventional budget planning” to a more demanding “public expenditure management” (see figure 8). Reforms of budget planning systems and MTEF procedures have been combined with the introduction of **performance-based budgets** in a number of countries. Traditional budgets calculate based on inputs, for instance the number of teachers employed. Performance is either measured in terms of output, e.g. the number of primary school graduates, or by the outcome (higher levels of literacy).

<sup>33</sup> PRSP-Sourcebook, Chapter 6, page 191

<sup>34</sup> PRSP-Sourcebook, Chapter 6, page 216

## **Box 8: The Theory and Practice of Budgets in Poor Countries**

### **GOOD BUDGETING PRINCIPLES ...**

**Comprehensiveness:** the budget must encompass all the fiscal operations of the government

**Discipline:** policy decisions with financial implications must be made against the background of a hard budget constraint and in competition with other demands

**Legitimacy:** decision makers who can change policies during implementation must take part in and agree to the original policy decision

**Flexibility:** decisions must be pushed to the point where all relevant information is available

**Predictability:** fiscal policy must take account of the need to ensure the timely flow of funds to spending units

**Contestability:** existing policies are subject to constant review and evaluation

**Honesty:** budgets are based on unbiased projections of both revenue and expenditure

**Information:** accurate and timely information on costs, outputs and outcomes is essential

**Transparency:** information about budget decisions must be accessible, clear and communicated to the wider community

**Accountability:** decision makers must be held responsible for the exercise of the authority provided to them

### **... AND POOR BUDGETING PRACTICES**

**Unrealistic planning/budgeting:** both plans and budgets are not a statement of intentions, but a wish list of political promises

**Short-term budgeting:** no consideration of medium-term implications of budgets, such as the recurring operating costs of new investments

**Repetitive budgeting:** the budget is frequently remade during the year, in response to economic or political conditions

**Cashbox budgeting:** government spends as cash becomes available, not according to preset budget priorities

**Deferred budgeting:** arrears build up as expenditures are pushed into subsequent years

**Distorted priorities:** scarce resources are spent on 'showcase' projects that produce meager social returns

**Declining productivity:** the size of the civil service expands in response to unemployment, but ghost workers, under investment in training and IT, and poor working conditions degrade operational efficiency

**Informal management:** extralegal arrangements dictate how government operates in recruitment, procurement, etc.

**Corruption:** lack of enforcement of formal rules breeds illegal behavior, which goes undetected and unsanctioned

*Source: ODI Briefing Paper 2004, page 2*

The monitoring of poverty reduction strategy programmes needs to connect public expenditure with the outcome attained by them. Traditional budgets do not provide this information; this is why donors and above all the World Bank favour performance-oriented budgeting. Some countries – e.g. Australia and South Africa – have had good experience with these types of reforms. But apart from the strengths of an outcome/performance base in budgeting (see box 14), handling the rather complex planning methods asks too much of most developing countries. If capacities are low, even an input-based budget system should be seen as success in many cases – if executed correctly. Performance-based budgets additionally lead to a mass of information which can no longer be read by parliaments or the public, let alone queried. A lack of transparency then hinders public accountability.

<b>Box 9: Strengths and Weaknesses of Public Expenditure Management Regimes</b>			
	<b>Strengths</b>	<b>Weaknesses</b>	<b>Good for situations with...</b>
Input	<ul style="list-style-type: none"> <li>■ Easy and affordable</li> <li>■ Strengthens compliance</li> <li>■ Facilitates control of aggregate expenditure</li> </ul>	<ul style="list-style-type: none"> <li>■ Does not support efficiency</li> <li>■ Can be inflexible</li> <li>■ Short term</li> </ul>	...low confidence and variable competence
Output	<ul style="list-style-type: none"> <li>■ Facilitates efficiency</li> <li>■ Accountability</li> </ul>	<ul style="list-style-type: none"> <li>■ Can distort focus</li> <li>■ Measurement problems</li> <li>■ Costs</li> <li>■ Information overload</li> </ul>	...confidence, sound accounting and Public service professionalism
Outcome	<ul style="list-style-type: none"> <li>■ Facilitates re-allocation</li> <li>■ Supports policy formulation and co-ordination</li> <li>■ Long term</li> </ul>	<ul style="list-style-type: none"> <li>■ Measurement problems</li> <li>■ Accountability problems</li> <li>■ Costs</li> <li>■ Information overload</li> </ul>	... the above and dedicated politicians
<i>Alex Matheson, OECD</i>			
<i>(GTZ – Eschborn Dialogue 2004, Workshop on Good Financial Governance, June 2004)</i>			

Budget planning and implementation are further made difficult by the absence of adequate **information systems**. There is often a lack of timely and appropriate financial information for decision making during planning and budget formulation as well as a lack of accurate financial management information during budget execution and non-existent or out-of-date financial reporting.<sup>35</sup> Consequently the compilation of sector ministries' budget proposals into one comprehensive budget, the elaboration of accurate accounting statements and of timely financial statements on the status of expenditures, the records management, especially in preparation for control purposes, are time consuming, incomplete and faulty.<sup>36</sup> Therefore a sound public financial management information system is an essential module of any reform.<sup>37</sup>

Many of the above problems express the limited performance of the institutions involved and strengthening personnel skills and technical systems is certainly imperative. However, sustained improvement requires a public which holds the government accountable for the results of their policies. This requires participation of those, who are supposed to benefit from the government's actions. Direct **participation in budget planning** is not feasible at central government level. There has, however, been good experience with participatory budgeting at local level. The best known example is probably Porto Alegre in Brazil, but the introduction of participatory budgeting models has spread more widely. In Germany there are at present 35 communities that have introduced models of this type<sup>38</sup>.

At central level, aligning public expenditure with citizens' needs primarily means compiling of data. **Systematic statistical services** are needed, but lacking in most countries - although countless donor-financed surveys concerning living conditions and other questions that are

<sup>35</sup> World Bank (1998), page 60

<sup>36</sup> Langhammer (2003), page 7

<sup>37</sup> World Bank (1998), page 82

<sup>38</sup> Floer (2004), page 1

relevant to the issue of poverty often exist. These surveys are helpful in the short term but do not replace the work of a functional national statistics service. Participatory survey methods also allow some direct participation in central government budget planning, e.g. with participatory poverty assessments. The key to improving participation is the promotion of a **culture of open communication** at different government levels and among civil servants, local political leaders and citizens groups.

### **Summary: Need for intervention on the expenditure side to ensure Good Financial Governance**

The following must be taken into account on the expenditure side:

- Budget planning must refer to all public expenditure, i.e. result in a comprehensive budget. Donors cooperate in this process by avoiding project budgets that are administered in parallel.
- The credibility of budget planning depends on the feasibility of spending ceilings. These require reliable forecasts, which are based on, the one hand, on macroeconomic stability and reliable donor contributions and, on the other hand, on the ability of the administration as a whole to plan its funding requirements appropriately. This is an enormous challenge for capacity development.
- Medium term financial planning is imperative but must not demand too much of the limited capacities and resources of institutions involved.
- Information systems are essential and must be designed in a reliable and user-friendly manner in line with the country's requirements.
- The reconciliation of public expenditure with citizens' needs additionally requires systematic statistical data. Direct participation options in budget planning should exist at local authority level.

### **3.4 Challenges and reform needs for external financial control**

Control systems are fundamental for Good Financial Governance because a properly functioning control system is vital to ensure accountability of the government to its citizens. In the current discussion, often combating corruption is named as an important task, but financial control extends far beyond this. INTOSAI (*International Organization of Supreme Audit Institutions*), published auditing guidelines in 1977 in the form of the "Lima Declaration" and defined the goals as follows:

"The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent - or at least render more difficult - such breaches."

In many countries, the reality is quite different. Analysis of the mechanisms to exercise accountability in HIPC countries by the IMF and the World Bank demonstrated that<sup>39</sup>:

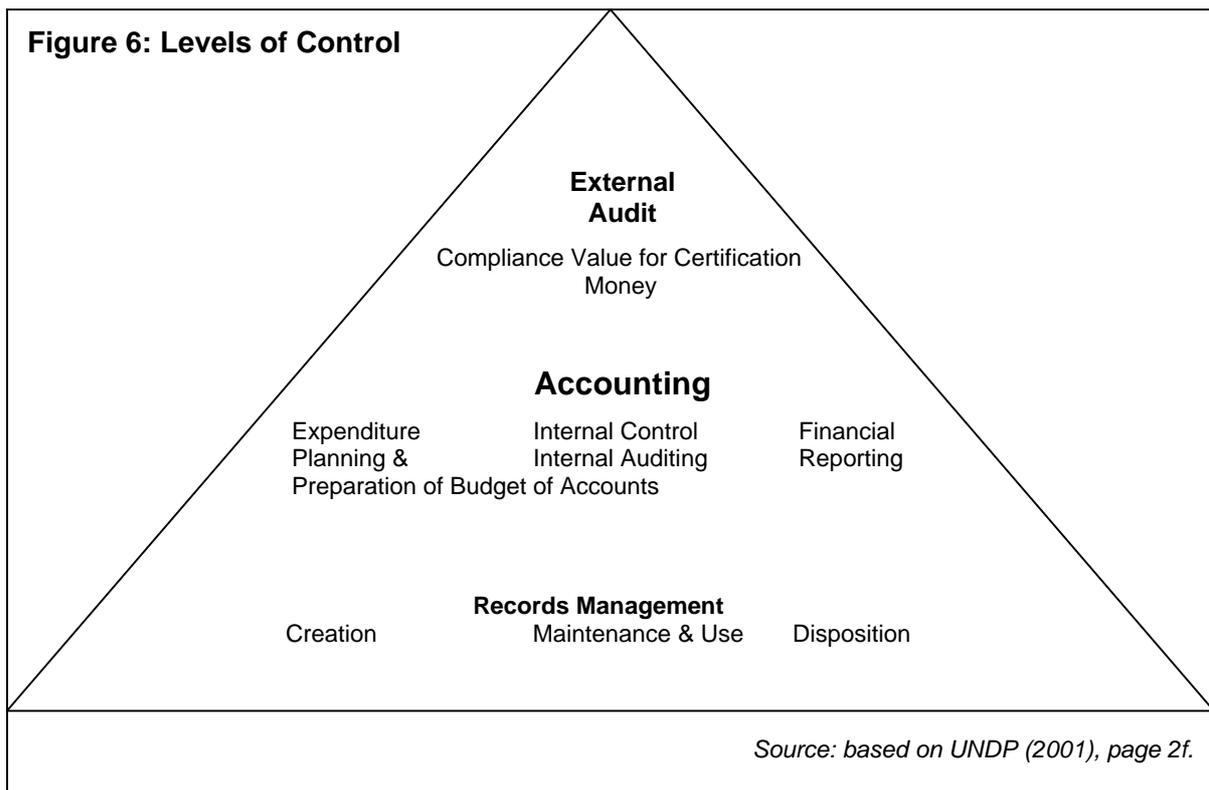
- 71% of countries could not close their budget accounts within two months after the end of the budget year. One third of them needed much longer;

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<sup>39</sup> See Langhammer (2003), page 8

- 88% could not present financial records organized by budget functions in a timely manner; only a third of these countries submitted any form of annual financial statement.
- 83% also did not have audited accounts 12 months after closing of the books.
- 88% did not maintain any active or effective internal accounting control systems.

The financial control systems of many developing countries are thus insufficiently developed, occasionally there is no regulatory framework for financial management and reporting and/or it is not in function, not well known and therefore not applied.



Control of the public budget involves three stages, as shown in figure 6:

- The supreme audit institution cannot work effectively if the lower levels do not supply the data to be audited. Reliable data requires **appropriate record-keeping** as a first step. The records must be created, maintained and used in a way that they reliably show actions with effect on the cash situation. The entire course of a transaction must be recorded and ultimately archived in such a way that it is available if required. All persons concerned with the administration of public funds must also maintain auditable bookkeeping records.
- The recorded information is used in three functions of state accounting: it serves for future expenditure planning, it forms the basis of internal control to ensure compliance with laws and administrative rules, and the financial reports are produced from the data, ranging from daily cashbooks to the formulation of short, medium and long-term financial planning. Effective financial management information systems for the administration of funds combine technical support to financial planning and reporting with control modules which define access rights accordingly and carry out data checks. **Internal audit** ensures

proper implementation of internal controls and is therefore essential in ensuring orderly administration. The fact that 88% of HIPC countries neglect internal control paints an alarming picture of the control situation in these countries.

- The **external audit** of the budget by the supreme audit institution based on the financial reporting is just the final layer in the control pyramid. Independent external control audits invoices as well as legality and efficiency, i.e. compliance with legal provisions, especially the budget law, and the proportionality between the expenditure and the benefits of government activities. The audit must be officially certified and an audit report must be prepared.

The **publication of audit results** represents the necessary bridge between control and accountability. Parliament plays the most important part in exercising public control but an active civil society and independent media also contribute to an efficient system of control. Ultimately an independent legal system is necessary in order to be able also to enforce legal actions relating to misappropriation of funds.

**Box 10 : IMF – Code of Good Practices on Fiscal Transparency**

- 1 a The government sector should be clearly delineated from the rest of the economy and the role of the fields of politics and administration within the government must be clearly defined.
- 1 b A clear legal and administrative framework should be binding for the public financial system.
- 2 a The public should receive complete information about previous, current and planned government activities.
- 2 b The state must undertake to publish reports and financial information on time.
- 3 a The documentation of the budget should specify the goals of fiscal policy, the macroeconomic framework conditions, the political basis of the budget and the most important, recognisable financial risks.
- 3 b The budget data should be classified and represented in such a way that they make it easier to analyse policy and strengthen accountability.
- 3 c The procedures concerning the use and control of the approved expenditure must be clearly specified.
- 3 d The reporting of the public finance should be on time, complete and reliable and state the budget trends.
- 4 The correctness of the budget information should be the object of a public and independent inspection.

*Source: Tanzi (1999), page 15*

This brief summary shows that the introduction of an effective budget control system must have a long term horizon. The IMF published a "Code of Good Practice" for budget transparency (see box 10), which compiles the most important principles for a regulation-based public finance system. In this process reform requirements may comprise the legal fundamentals, organisation, auditing procedures and techniques, human and material resources as well as training. However, the capacity of all the institutions of the public finance system is of vital importance in ensuring the effectiveness of the supreme audit institution.

**Summary:****Fields of action for Good Financial Governance in the system of external financial control**

The following aspects are necessary to ensure effective control of the public financial system based on the principles of Good Financial Governance.

- Appropriate records must reliably reflect actions that have an effect on the cash situation, the entire period of a transaction must be recorded and archived in such a way that it is available if required.
- The data should, on the one hand, be used for future expenditure planning and, on the other, for internal control as well as financial reporting.
- Effective external control of the data supplied by the lower levels is necessary. Thus reforms which only apply to the Audit Office are very probably too limited.
- Even if public administrative departments are sufficiently efficient, Good Financial Governance only happens if the control results can be, and are, used by the public to make the government accountable and an independent judiciary secures penalty under the rule of law for the misuse of funds.

#### **4. Capacity development in the reform of public finance: The German Development Cooperation approach**

In the previous chapter it has become obvious that reforms aiming at good financial governance are far reaching within the public sector and represent a highly sensitive political issue. They cannot be driven from outside, but need the country's leading role and ownership. Donor contributions to good financial governance therefore need to coordinate their efforts under the umbrella of a governmental reform programme.

**Experience with the implementation of public finance reform.** German Development Cooperation can look back on many years of extensive experience with the implementation of components of reform programmes in the field of public finance. This includes assistance in reforms of public revenue systems (customs, fiscal policy and tax administration), enhancing transparency and accountability through cooperation with partners in the establishment of efficient structures of public financial management, and the introduction of external budgetary control through support of SAIs. The characteristic feature of the experience gained to date is the "connectivity" of German Development Cooperation, i.e. the willingness and ability to embark on a coordinated course of action together with other donors.

**Box 11: Reform policy in a politically sensitive environment:  
The Senior Budget Officials (SBO) Initiative**

Within the framework of the SBO Initiative the GTZ supports the development of regional networks of budget directors, e.g. in South Eastern Europe and Africa. The approach is based on the long-term positive experience of the OECD countries of such a form of exchange. The GTZ has now created the preconditions together with the Federal Ministry of Finance (BMF) and the OECD, to allow developing countries and countries in transition to benefit from this experience. In this way dialogue on a very sensitive political issue is promoted and experience and reform requirements are openly discussed. A new instrument will be developed by means of this initiative, extending the expertise of German Development Cooperation in support of budget reforms.

*Source: GTZ (2005a)*

In this process, experience shows that reforms of the budget system in particular must be treated with political sensitivity. German Development Cooperation participates in some encouraging regional approaches in this area (see box 11).

Most bilateral and multilateral donors and executing agencies promote partner orientation of development cooperation. However, differences arise when it comes to implementation. German Development Cooperation can make a contribution in this area, the example of budget reform in Jordan shows that the partner's priorities can be identified with the aid of partner-oriented approaches and can be embedded within an overall concept to strengthen Good Financial Governance (see box 12).

**Box 12: Partner-oriented budget reform: The example of Jordan**

The development of a master plan for the reform in public finances in 1999 paved the ground for the introduction of a performance-based budgeting system in Jordan that won the support of bilateral and multilateral donors. While the reform was being implemented the concepts turned out to be too ambitious and not suited for the specific situation in Jordan. A concentration on fundamental problems of budget management, their relevance to Good Governance and a corresponding reorientation of the reform programme in 2002 helped to go ahead and develop new motivation. The GTZ helped to provide the capacities for a valid estimation of the underlying data. At the beginning of the year spending ceilings were introduced which brought the urgently necessary budget discipline.

*Source: GTZ (2005b)*

In addition, there has been positive experience in creating transparency and accountability. Improving levels of transparency and the introduction of regulatory compliance will not only address the goal of combating corruption, but in general the abuse of power can be recognised and penalized more effectively by means of institutional reform and redefining areas of responsibility. The first important steps have been taken to increase levels of transparency by introducing adequate external control mechanisms, as the example of the reform of fiscal control in Mongolia shows (see box 13).

**Box 13: Enhancing transparency: Introduction of external budgetary control in Mongolia**

In the course of the political and economic changes in Mongolia the communist budgetary control was abolished in 1990 and external budgetary control based on democratic principles introduced in 1995. Since 1998 this process has been supported by GTZ in cooperation with audit offices of the German Lander. Effective structures were set up, modern auditing procedures introduced and, above all, a change in the way of thinking brought about regarding the role of external audits. This, on the other hand, contributes to an economical and proper functioning of the administration in Mongolia.

*Source: GTZ (2004b)*

**Comparative advantages and special features of German Development Cooperation.**

Based on the German Development Cooperation's experience implementation special emphasis must be placed on the firm focus on players at political level and on the ground (ownership by the partners), supporting the partner in structuring reform processes, constant on-site commitment and a multilevel approach. The latter not only comprises the political levels (micro, meso and macro) but also includes the whole range of government institutions (central government, intermediate and local level). Above all, the long-term support for reforms by experienced experts in the partner organisation makes it possible for German Technical Cooperation (TC) in particular to assess the needs and capacities of the partner countries. The fact that German TC, unlike other development cooperation organisations, provides support without stipulating conditions during the reform of the public financial system, is viewed in a very positive light, strengthens the level of ownership in the partner country and encourages the preparation and implementation of a feasible reform approach not driven by the comparatively short-term and often all too demanding conditions of donors (capacity building).

Another outstanding feature which characterizes German Development Cooperation is its national and international connections to German and European revenue and audit administrations, research institutions and regional organisations specialising in budget and tax matters. This networking allows to contribute to the design of reform processes and provide the well adapted expertise. Against the background of many cooperation with bilateral and multilateral organisations (IMF, World Bank, OECD, DFID, DANIDA, etc.) this type of cooperation allows for a concentration of specialist, academic, administrative and development policy know-how. The partners perceive German Development Cooperation executing agencies as close to government corporations, which are considered particularly trustworthy when it comes to the reform of sovereign areas.

The Good Financial Governance approach closes a gap that had previously existed in the work of German Development Cooperation: only the targeted application of the principles of Good Governance to all the subsystems of the public finance, i.e. a systemic Good Financial Governance approach, will enable sustained reform of public finance in developing countries.

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## **Appendix**

### **Overview of the presentations of the workshop on “Good Financial Governance: How to Ensure the Accountable Use of Public Funds?” Eschborn Dialogue 2004**

Cole, Neil (2004), Public Expenditure Management Reforms, Experience in South Africa.

Diamond, Jack (2004), IMF View on Good Financial Governance

Fjeldstad, Odd-Helge (2004), Taxation and Accountability

Kraemer, Moritz (2004), Sovereign Ratings and Public Finances in Emerging and Developing Countries

Kuteesa, Florence Nightingale (2004), Good Financial Governance in Uganda

Matheson, Alex (2004), The Implications of OECD Budgetary Reforms for the Developing World

Otieno, Gladwell Wathoni (2004), Good Financial Governance in Kenia

Razzaq Dardari, Abdallah Abbdel (2004), Challenges of Reforming Public Sectors and Public Financial Management – the Perspective from a Ministry

Van Kommer, Victor (2004), The Tax Policy Issues for Developing Countries and Countries in Transition

The official documentation of the Eschborn Dialogue 2004 can be found at:

<http://www.gtz.de/de/dokumente/de-efta-abschlussbroschuere-2004.pdf>

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