ECONOMIC GOVERNANCE: KEY TO DEVELOPMENT?
Introduction to the debate

1. **Economic governance**

<u>What is economic governance?</u>

Initially developed to account for forms of corporate management (Corporate Governance), the concept of governance was extended to the sphere of public affairs at the end of the 1980s.

This new usage of the term first appeared in 1989 in a World Bank study on the very poor performances of Sub-Saharan African economies during the 1980s.[1] A brochure published in 1992[2] developed the concept and made improving governance in developing countries a major Bank objective.

In this brochure, the World Bank differentiates between three distinct dimensions of governance: (a) the form of the political regime; (b) the processes whereby authority is exercised on management of the country's economic and social resources; and (c) the capacity of the government to conceive, formulate and apply policies and, in general, to implement governmental functions. It points out that the first dimension lies beyond its mandate and therefore focuses its attention only on the second and third dimensions. Consequently, it defines governance as "the manner in which power is exercised in the management of a country's economic and social resources for development." In this framework, it highlights four aspects of governance that it deems essential: (a) the management of public finances; (b) accountability; (c) the legal and regulatory framework; (d) transparency and information.

In the rest of this text, we will further narrow the field of economic governance to the management of public finances alone, as the issues of accountability, transparency and information are only taken into account to the extent that they have to do with the process of public financial management.

However, it should be said that some donors have a far wider understanding of governance than the World Bank.

Accordingly, for the UNDP[3], governance is "the exercise of political, economic and administrative authority for the purpose of managing a country's affairs. It rests on

1 World Bank, Sub-Saharan Africa – from Crisis to Sustainable Growth, 1989
2 World Bank, Governance and Development, 1992
3 United Nations Development Programme, Governance for Sustainable Human Development, UNDP Policy document, New York, 1997

mechanisms, processes and institutions that enable citizens and groups to express interests, settle disputes and have rights and obligations." Within governance, the UNDP distinguishes between three types of stakeholders, each having its own responsibilities: the state, the private sector and civil society.

The European Commission, for its part, speaks of democratic governance, highlighting its multidimensional character[4]: "There is no particular institutional model for democratic governance, which simply affirms the rights of all citizens on the road to sustainable development. It includes: respect for human rights and fundamental freedoms (including freedom of expression, information and association); support for democratisation processes and the involvement of citizens in choosing and overseeing those who govern them; respect for the rule of law and access for all to an independent judicial system; access to information; a government that governs transparently and is accountable to the relevant institutions and to the electorate; human security; management of migration flows; effective institutions, access to basic social services, sustainable management of natural and energy resources and of the environment, and the promotion of sustainable economic growth and social cohesion in a climate conducive to private investment."

One might ask whether such a broad definition of governance, which places equal importance on principles (rule of law, independent judiciary, accountability, etc.) and what may be expected (access to basic social services, sustainable management of resources, etc.), is still operationally useful in orienting aid action for development.

Evaluation of economic governance

Governance is the yardstick against which donors judge the quality of the institutions and policies of countries receiving their aid. This desire to make a judgment requires instruments to be developed with which to measure the quality of governance and, in the case in hand, economic governance on a scale of values capable of distinguishing good from poor governance.

By virtue of the diversity of aspects it covers, governance gives rise to multiple indicators. Through the World Governance Indicators, The World Bank provides a summary of some 30 indicators grouped into six dimensions:

- Voice and accountability;
- Political stability and the absence of violence;
- Government effectiveness;
- Regulatory quality;
- The rule of law;
- Control of corruption.

These indicators, which score from -2.5 to +2.5, cover the period 1996-2013 for 215 countries.

The government effectiveness indicator, which may a priori seem close to the concept of economic governance in the sense given above for this term, in fact, combines economic

4 Governance in the European Consensus on Development; Communication from the Commission to the Council, the Parliament, the European Economic and Social Committee and the Committee of the Regions, August 2006

governance in the strict sense and the results thereof. It takes into account not only the formulation of public policies and their implementation, or the government's commitment to applying the stated policies, but also the results of the policies implemented, such as the quality of the administration and public services.[5]

The World Bank focuses on the policies and institutions of the countries evaluated (Country Policy and Institutional Assessments or CPIA) broken down into four domains and 16 indicators:

A. Economic management
1. Monetary policy and exchange rate management
2. Budgetary policy
3. Debt policy and management

B. Structural policies
4. Foreign trade
5. Financial sector
6. Regulatory environment for business

C. Social inclusion and equity policies
7. Gender equality
8. Fairness in terms of the use of resources
9. Development of human resources
10. Welfare protection and right to work
11. Environmental management policy and institutions

D. Public financial management policies and institutions
12. Ownership rights and application of the law
13. Quality of budgetary and financial management
14. Efficiency in terms of the mobilisation of resources
15. Quality of public administration
16. Transparency, accountability and corruption in the public sector

The Country Performance and Institutional Assessments (CPIA) evaluate the quality of the institutions and policies on a scale of one to six relating to their assumed capacity to contribute to the reduction of poverty, sustainable growth and the efficient use of aid for development. They play an important role in estimating the Country Performance Ratings, one of the elements taken into account in the allocation of International Development Agency (IDA) funds among the countries eligible for this resource.

The indicators for domain D (public financial management policies and institutions) and particularly CPIA 13 (Quality of budgetary and financial management) are very much in line with the field of economic governance in the narrow sense that we are addressing here. CPIA 13 assesses the quality of budgetary and financial management on the basis of three dimensions: (a) the comprehensiveness and credibility of the budget and its link to priority policies; (b) the existence of efficient management systems ensuring that the implementation of the budget is controlled and predictable; (c) precise accountancy and budgetary reports supplied on time and audited.

5 Kaufmann D., Kraay A. and Mastruzzi M., The World Governance Indicators Methodology and Analytical Issues, World Bank, Policy Research Working Paper No. 5430, September 2010

Two criticisms have, however, been made of CPIA 13[6]: it provides no information on the strengths and weaknesses that justify the assessment made of the public financial management system; the assessment of the public financial management of some countries, in respect of which, remember, it plays a role in the allocation of IDA resources, may have been influenced by the Bank's lending policy.

An alternative gauge of the budgetary and financial dimension of the quality of economic governance, which is not subject to the criticisms made of the CPIA, is Public Expenditure and Financial Accountability (PEFA). PEFA diagnoses are designed to provide a detailed evaluation of "the operational performance of the main elements of the public financial management systems, procedures and institutions." It is based on a battery of 28 performance indicators (PI) covering six dimensions: (i) budget credibility; (ii) comprehensiveness and transparency; (iii) budgeting based on national policies; (iv) predictability and control of budgetary performance; (v) accountancy, recording of information and financial reports; (vi) monitoring and external verification. There are three further indicators relating to donor practices that do not concern us here.

Each of the PEFA indicators are assessed from A (very satisfactory) to D (very unsatisfactory) by reference to four precisely described standard situations. Some indicators take into account different aspects or components of the domain considered. For example, the indicator for transparency in intergovernmental budgetary relations (indicator PI-8) comprises three components: transparency and objectivity in the horizontal distribution of allocations between decentralised administrations; communication within the required time of reliable information to decentralised administrations on their allocations; the degree of budgetary data consolidation by the general administration in accordance with sectoral categories. If, in principle, the assessment of a composite indicator corresponds to the assessment of its weakest component, more favourable assessments of other components of the indicator modify the evaluation of the latter, for example, from C to C+.

At the end of March 2015, 418 PEFA diagnoses had been made in 149 countries. Of these, 256 were rerun diagnoses, making it possible to assess how the performance indicators evolved between the dates on which these diagnoses were made[7].

6 See in particular: de Renzio P., Andrews M., Mills M., Does donors' support to public financial management reforms in developing countries work?, ODI Working Paper No. 329, April 2011.

7 PEFA, News Flash, April 2015

2. **Why do donors want to contribute to improving economic governance and particularly public financial management in countries receiving aid?**

The quality of economic governance is thought to have a positive impact on the effectiveness of the aid

The justification for donors' interest in the quality of governance in countries receiving aid lies in its significant impact on growth and poverty reduction and, therefore, on the effectiveness of aid for development.

One pioneering research report into the relationship between the quality of institutions and policies, and the effectiveness of aid to promote development was "Assessing aid: What works, what doesn't work and why" published by the World Bank in 1998[8] then updated several times by its authors, Craig Burnside and David Dollar[9]. This study concluded that aid to promote development contributes to accelerating economic growth in countries with healthy institutions and policies but has little or no effect in countries where the institutions and policies are of mediocre or poor quality. It led to a considerable amount of literature on the subject, some studies supporting the conclusions reached by C. Burnside and D. Dollar, others concluding that aid is effective in all cases and therefore the quality of governance is not a factor for aid effectiveness. Finally, some other studies even maintain that aid for development has no positive effect on growth regardless of the quality of governance.

Furthermore, the study by C. Burnside and D. Dollar led to research more specifically addressing the effects of a particular component of governance on the effectiveness of aid, here again with mixed results[10]. However, studies concerning the effects of economic governance, and more specifically the effects of good quality public financial management, are rare.

The fact remains that, despite the lack of converging conclusions reached by the econometric studies on the relationship between the quality of governance and the effectiveness of aid, donors consider that the logical evidence points to the existence of a positive relationship between the quality of governance and performances recorded by developing countries in terms of economic growth and poverty reduction and, consequently, between the quality of governance and the effectiveness of aid.

Specifically concerning the quality of public financial management, the arguments made in favour of its positive impact on growth and poverty reduction are as follows:

- Quality public financial management guarantees fiscal discipline, preventing the development of unsustainable budgetary deficits, which are a source of economic instability (high inflation, high interest rates, increasing deficits in the current balance of payments) and discourage private investment;

8 World Bank, Assessing aid: What works, What doesn't work and Why?, 1998

9 Burnside C. & Dollar D., Aid, Policies and Growth, American Economic Review, 90:4 September 2000; Burnside C. & Dollar D., Aid, Policies and Growth: Revisiting the Evidence, World Bank Policy Research Working Paper No. 3251, March 2004

10 A review of these studies can be found in the chapter on the pertinence of CPIA in the evaluation of this instrument by the World Bank Independent Evaluation Group: The World Bank's Country Policy and Institutional Assessment, An Evaluation, World Bank, 2009

- It enables fiscal resources to be allocated to sectors in accordance with the priorities of government policy, contributing to the achievement of the objectives formulated in strategic documents on growth and poverty reduction;
- Rigorous recording in good time of expenditure guarantees close monitoring of budgetary performance, enabling corrective measures to be adopted, if necessary, and contributing to full use of resources;
- The internal and external monitoring of public expenditure ensures that it is consistent with the budget passed and that procedures are complied with, in particular in the awarding of contracts, enabling public authorities to obtain the best quality/price ratio from public expenditure; accordingly, it contributes to improving the efficiency of public expenditure to the benefit of the public.
- Transparent, fair and effectively applied taxation increases the state's resources and therefore its capacity to act;
- Greater transparency in public financial management through public access to budgetary forecasts, performance reports, financial statements and external verification reports makes the government accountable to the public for the use that it makes of the state's resources and the compliance of its management with the guidelines stated in the development strategy.

<u>The quality of public financial management is an essential element of the involvement of development aid agencies</u>

But development aid agencies have another reason for being concerned about public financial management in countries receiving aid from them.

As long as donors provided predominantly project aid and managed this aid using their own means, or through the intermediary of project management units, applying rules and procedures defined by the donors themselves, the aid agencies could easily demonstrate to their clients that they were handling the funds entrusted to them diligently and could account for their actions in terms of physical performance.[11]

The allocation of a fraction of development aid in the form of payments to state budgets (budget aid), the cancellation of debt[12] and, more generally, the increasing use by donors of beneficiary state management systems applying the Paris Declaration and subsequent recommendations rendered this method of reporting obsolete.

Certainly, budget support and debt relief only amount to a very modest fraction - less than 10% - of development aid.

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11 However, we know that due to the fungibility of public expenditure, this demonstration of the achievements of aid could be misleading.

12 Inasmuch as the abandonment of bad debt can be considered to be within the ambit of aid.

Official development assistance commitments - all donors

	2005	2006	2007	2008	2009	2010	2011	2012	2013
In millions of $US at current rates									
Sectorisable aid	113 312	116 378	122 612	145 797	142 610	154 861	157 665	163 199	174 719
Budget support	3 323	3 113	4 701	8 130	7 409	4 934	4 433	4 495	9 139
Debt relief	26 053	23 203	13 753	11 291	2 747	4 869	4 521	3 203	3 769
Expressed as a percentage of sectorisable aid									
Budget support	2.9%	2.7%	3.8%	5.6%	5.2%	3.2%	2.8%	2.8%	5.2%
Debt relief	23.0%	19.9%	11.2%	7.7%	1.9%	3.1%	2.9%	2.0%	2.2%

Source: OECD/DAC

However, as the OECD report on the implementation of the Paris Declaration for 2014[13] reveals, approximately half of the development aid disbursal made in 2013 to government authorities used public financial management systems in the countries receiving aid: execution of the expenditure by the administration of the recipient country (53.1%), financial reporting on the basis of beneficiary country practices (50.4%), auditing of the expenditure by the Court of Audit of the beneficiary country (50.5%), use of beneficiary country contract award procedures (41.7%).

In these circumstances, the only way for aid agencies to demonstrate their concern for the diligent management of funds placed at their disposal and to reassure their clients that these funds produce achievements is to ensure that public financial management in beneficiary countries is as healthy as the level of development of the countries receiving the aid allows[14]and, if necessary, to contribute to improving the quality thereof.

13 OECD/UNDP, Making Development Cooperation More Effective: 2014 Progress Report, 2014

14 A strong correlation exists between a country's per capita GDP and its public financial management system. See Chapter 4.

3. **What actions have donors taken to improve economic governance in countries receiving aid?**

Increase in aid for improving public financial management

The OECD/DAC data bank on official development assistance gives a breakdown by sector for the period 2005-2013 of DAC member donor commitments. One of the sectors that stands out in these statistics is that of aid to governments and civil society.

These figures, which can be assumed to cover aid for improving governance in the broadest sense, including those aimed at strengthening the capacity of civil society organisations to influence public decisions, show no significant increase in the relative value of aid to this domain.

Official development assistance commitments - aid to governments and civil society
In millions of current $US

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Sectorisable aid	113 312	116 378	122 612	145 797	142 610	154 861	157 665	163 199	174 719
Government and civil society	11 018	11 536	13 248	14 100	14 387	14 933	17 534	15 257	15 725
Gvt and civil society expressed as a percentage	9.7%	9.9%	10.8%	9.7%	10.1%	9.6%	11.1%	9.3%	9.0%

Source: OECD/DAC

Specifically concerning aid for economic governance, Paolo de Renzio, Matt Andrews and Zac Mills[15] obtained communications from DAC of official assistance commitments targeting improvement of public sector financial management. On examination of this data, however, it turned out to be unusable as it included projects that are only tenuously related to public financial management, so, unlike the interventions relating directly to this domain, it was not taken into account. In the light of this situation, de Renzio and his co-authors conducted a direct survey of 13 aid agencies for which DAC statistics gave reason to believe that they provide 90% of aid to public financial management. It transpired from this survey that the amount of aid for public financial management supplied by this group of donors increased from approximately $US60 million in 1995 to over $US400 million in 2008. These results attest to the fact that the donors are focusing increasing attention on public financial management and, over recent years, have devoted significantly increasing resources to it, although the figures considered are low compared with the overall amount of official development assistance.

This assessment is supported by an evaluation of the 467 programmes in support of public sector reforms financed by the World Bank between 1999 and 2006. The evaluation report[16] notes that the sums allocated to public financial management within public sector reform loans increased, on average, from $129.6 million per year over the period 1990-1999 to $912.0

15 De Renzio P., Andrews. and Mills Z., Does donor support to public financial management reforms in developing countries work? ODO Working Paper No. 329, April 2011

16 World Bank, Public Sector Reform: What works and why, World Bank Independent Evaluation Group, 2008

million per year for the period 2000-2006. In parallel, the subsidies for institutional development (IDF grants) targeting public financial management increased between the same dates from 3% to 18% of the total amount of these donations. Finally, conditions relating to public financial management associated with Development Policy Loans from the Bank increased, whereas the overall number of conditions tended to decrease.

Form and purpose of aid for improving public financial management

While no reliable statistics exist on the overall amount of aid allocated by donors to public financial management, neither do many exist on the form that this aid took, or the aspects of public financial management targeted.

Consequently, we will limit ourselves to some qualitative observations of the characteristics of World Bank and European Union aid in this domain.

The assistance provided by the World Bank for improving economic governance falls into three categories:

- The diagnosis of public finance systems: Public Expenditure Reviews and Public Expenditure Tracking Surveys, as well as Country Financial Accountability Assessments, Country Procurement Assessments and Integrated Fiduciary Assessments. These reports, although produced first and foremost for the needs of the Bank, are a useful source of information for governments wishing to correct weaknesses in their public financial management systems. The evaluation of the Bank's activities in the domain of public sector reforms[17] indicates that at the end of 2006, fiduciary assessments that were five years old or less were available for 85% of the countries eligible for IDA. Furthermore, the World Bank itself or in association with other donors produces PEFA diagnoses that differ from the diagnoses mentioned above inasmuch as they are made in close cooperation with the governments concerned.
- Institutional Development Grants (IDG) for capacity development operations. Between 1995 and 2006, the bank awarded 256 IDGs, 191 (74.6%) of which related to public financial management (185 IDGs) or tax administration (6 IDGs).
- The financing through loans of programmes exclusively targeting the implementation of public financial management reforms or, more frequently, programmes in which public financial management reform activities, were a component of a broader initiative. Of 1,764 programmes initiated by the World Bank between 1980 and 2015 within the framework of what it terms "Governance Global Practice," 734 (41.6%) had a public financial management component accounting for 25% or more of their budget. The public financial management component of these projects frequently includes major investment for the creation of integrated financial management and information systems or the development of e-government services.

Through its IDGs and its loans, the World Bank has actively promoted the elaboration of Medium Term Expenditure Frameworks (MTEFs) and recent work gives reason to believe that they are contributing to an improvement in performance in terms of budgetary discipline and

17 World Bank (2008), op. cit

the allocation of resources.[18]

With regard to the European Union, the examination of 18 country evaluations by ADE comprising an evaluative question on aid for public financial management and its effects shows that with the exception of some technical assistance projects, mainly in former Soviet Union countries where public financial management systems had to be entirely reconstructed, EU aid for improving public financial management mostly formed part of budget support programmes, the purpose of which generally extends further than the simple reform of public financial management.

One of the conditions of eligibility for a developing country seeking European Union budgetary support, regardless of the purpose, is, in fact, the existence of a pertinent and credible public financial management reform programme. Pertinence refers to the extent to which the major shortcomings in public financial management - as identified by PEFA diagnosis - are addressed by a reform programme. Credibility relates to the appropriate nature of the sequencing, institutional provision, the political will to undertake reforms and the results of their implementation.

The performance of a budget support programme, in particular the disbursal of annual tranches, requires that this initial condition is maintained throughout the entire duration of the programme.

While this condition of eligibility and execution of budget support has been present in EU programmes since it undertook to supply part of its aid in this format at the end of the 1990s, a new condition was introduced more recently. It concerns budgetary transparency and supervision. Eligibility for a budget support programme is conditional upon publication by the government either of the draft budget by the executive, or the budget adopted for the preceding or current budgetary cycle. The performance of the budget support programme is subject to satisfactory progress concerning availability to the public of timely, comprehensive, good quality budgetary information.

Within the framework of these budget support programmes, European Union aid for improving the quality of public financial management operates on various levels and takes various forms:

- Financially, potentially in association with other donors, a PEFA diagnosis of the management of public finances;
- Provision of technical assistance to the government for formulation of the public financial management reform programme;
- Consideration in the budget support programme budget of all or part of the costs attributable to the public financial management reform programme;
- Inclusion in the budget support programme of public financial management performance indicators, which have an impact on the variable tranche actually disbursed;
- Political dialogue with the government on the implementation of the public financial

18 See Chapter 5

management reform programme;

- Supply of technical assistance for the implementation of some components of the public finance management reform programme, upon government request and on the basis of the often very limited resources earmarked for this purpose in the budget support programme budget or on the basis of other resources of the EU aid national indicative programme.

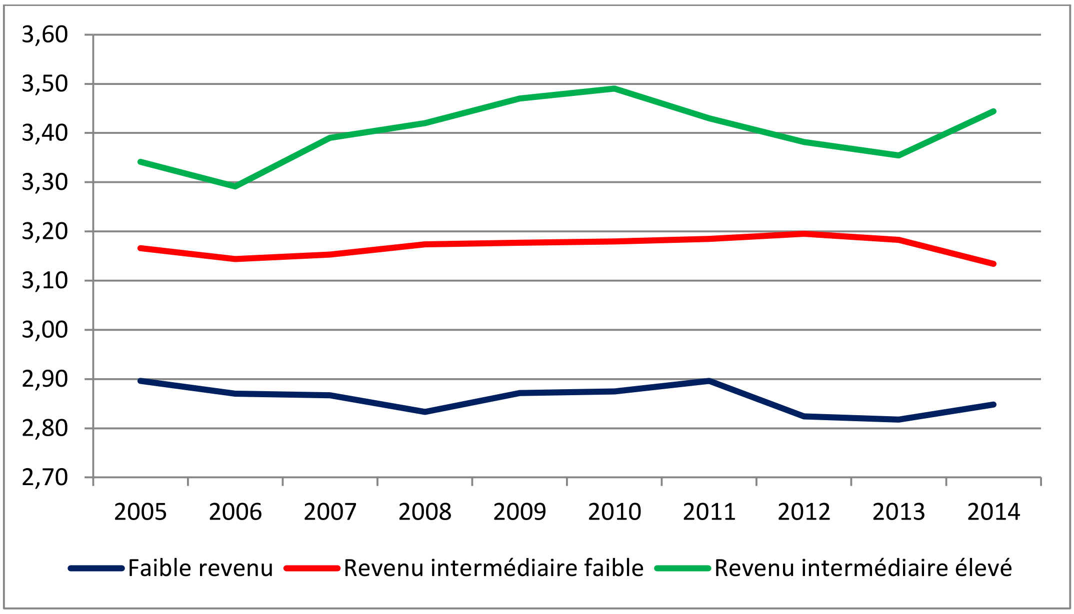
With a view to correcting the main shortcomings in the public financial management system detected by the PEFA diagnosis, EU aid for public financial management reform aims, according to the recommendation made by Allen Schick, “to put the basics right,” with, however, in some cases, prolongation towards the elaboration of a Medium Term Expenditure Framework (MTEF) or change from a conventional budget to a programme budget.

4. **Does the attention given by donors to economic governance contribute to improving its quality?**

<u>Statistical observation</u>

Since 2005, the World Bank has published CPIA indicators for countries eligible for IDA loans. The following graph shows the evolution of CPIA 13, which, remember, reflects the assessment made by the Bank on the quality of budgetary and financial management for low-income countries, lower middle-income countries and upper middle-income countries. The CPIA is expressed by a score ranging from one (very poor) to six (very good).

Graph 1: Evolution of CPIA 13 (2005-2014)



This graph gives rise to two comments:

- The quality of budgetary and financial management, as assessed by CPIA 13, shows no trend towards improvement over the 10-year period considered in the three groups of countries. It would seem, therefore, that interventions by donors to support the improvement of public financial management has had no effect, at least on the level of the groups of countries classed by level of income.
- The quality of budgetary and financial management is higher for upper middle-income countries than it is for lower middle-income countries, and higher in the latter than in low-income countries. Clearly, we cannot tell from this observation whether public financial management of good quality contributes to an increase in GDP. If a cause and effect relationship exists between these variables, it will most probably lie in the effect of per capita income on public financial management, as middle or high-income countries are able to devote human and material resources to this that cannot be accessed in poorer countries.

<u>Econometric analyses</u>

Paolo de Renzio et al.[19] tried to answer the question posed in the title of this chapter through econometric analysis of the relationship between the quality of public financial management and a number of variables, including the amount of aid for improving public financial management supplied by donors. An initial analysis of some one hundred countries used the average assessment of all of the 28 PEFA performance indicators for these countries to indicate the quality of public financial management, as these assessments are converted into scores ranging from one to four. One drawback of this approach is that using PEFA assessments for a given date made it impossible to reveal any evolution over time in public financial management in the countries concerned. To overcome this difficulty, the authors conducted a second analysis on a reduced sample of 19 African countries using public finance management quality indicators combining PEFA assessments and assessments made by the IMF and the World Bank to assess the public financial management of countries eligible for the Heavily Indebted Poor Countries (HIPC) initiative.

This work revealed that:

- The differences in the quality of public financial management from one country to another is primarily explained by socio-economic variables: GDP per capita, the rate of growth in GDP, population, openness to foreign trade[20] and dependence on primary commodity exports. As mentioned above in respect of the CPIA, the observation of a correlation between the quality of public financial management and the level of GDP or its rate of growth clearly does not imply that an improvement in the quality of public financial management would boost economic growth. The relationship is more probably the reverse: quality public financial management improves with the level of development. Therefore, we might ask whether interventions designed to improve public financial management in countries with a low level of development are not destined to experience relative inefficiency in the short and medium term.

- However, the quality of public finance management correlates positively to aid targeting this domain or, to put it another way, the quality of public financial management increases, the more aid for improving public financial management the countries receive, particularly in the form of technical assistance. Nonetheless, the authors do note that (i) the effects of aid are poor: an increase in the volume of aid for improving a country's GDP amounting to $US40 to 50 million would contribute to an improvement of half a point in its PEFA score (which is the equivalent of an assessment changing from a C to a C+) and (ii) it cannot be ruled out that this positive relationship between the volume of aid and the quality of public financial management may be explained by donors' inclination to supply more aid for this domain to countries that already have a relatively good quality of public financial management, or whose quality of public financial management is improving.

- The relationship between the quality of public financial management and the

19 Paolo de Renzio et al. (2011), op. cit

20 The authors note with surprise and are unable to explain why the econometric relationship between openness to trade and the quality of public financial management is negative: greater openness to foreign trade appears to contribute to a deterioration of the quality of public financial management.

proportion of aid for development supplied in the form of budget support is also positive. But here again, it may be asked whether the cause and effect relationship is not the effect of public financial management on budget support rather than the other way round; donors, concerned about their accountability, may be far more inclined to provide budget support to a country whose quality of public financial management reassures them regarding the use that will be made of their aid[21].

- Aid for public financial management extended over several years contributes to the achievement of significant results (i) in phases upstream of the cycle of public expenditure (preparation and adoption of the budget) but less clearly downstream (recording and accountability reporting, external and internal checks), (ii) in the introduction of new procedures without this always being accompanied by effective implementation of these procedures and (iii) preferably in processes involving a small number of central stakeholders, typically, the ministry of finance.
- Unlike the duration of aid, the volume of aid correlates positively to progress in the stages upstream of public financial management. De Renzio et al. attribute this result to projects aimed at putting in place integrated management and financial information systems to improve the recording of operations and accountability reporting, the cost of which is high and, therefore, takes up the lion's share of the volume of aid earmarked for public financial management.

Taking advantage of the increase in the number of countries for which a PEFA diagnosis has been made and the increasing number of rerun diagnoses, which makes it possible to assess how the quality of public financial management has evolved, Vera Fritz, Stephanie Sweet and Marijn Verhoeven carried on the work by de Renzio et al. on structural factors affecting the quality of public financial management[22].

Unlike de Renzio, after converting the PEFA assessments into scores ranging from one to four, Fritz et al., rather than using the average score of all PEFA performance indicators to determine the quality of public financial management, adopted the average score of the indicators for public expenditure alone, leaving aside indicators relating to budgetary discipline and taxation[23].

This difference does not fundamentally change the results. Fritz et al. find that the country's socio-economic characteristics, particularly their per capita GDP and its rate of growth, are determining factors of the quality of public financial management. These structural factors "would explain" 40% of the variations in public financial management in the sample of 120 countries studied. However, the authors also mention that there is a very great dispersion of countries either side of the regression line representing the relationship between the per capita GDP and the public financial management quality indicator. Accordingly, for example, Belize and Peru, both Latin American countries, have a very similar level of per capita GDP. But

21 This reservation does not relate to the European Union, which makes provision of budget support conditional upon the existence of a public financial management reform programme rather than a minimum quality of public financial management.

22 Fritz V., Sweet S. and Verhoeven M., Strengthening Public Financial Management: Exploring Drivers and Effects, World Bank Policy Research Working Paper No. 7084, November 2014

23 Indicators PI-5 to PI-28 excluding indicators PI-13 to PI-15

whereas Peru has a public financial management quality indicator very much higher than would be expected from the statistical relationship between the per capita GDP and public financial management quality, Belize is notable, on the contrary, for its very poor public financial management quality, which is comparable to that of Iraq or Haiti. The quality of public financial management is therefore not attributable to any structural socio-economic inevitability that would render any attempt to improve it redundant. While a low per capita GDP is a handicap for implementation of a well performing public financial management system, this handicap can be overcome.

In addition, this time analysing temporal variations of the GDP indicator, Fritz et al. observed that while socio-economic variables have a significant impact on the quality of public financial management, they do not impact its evolution. The key factor in the case of the variations recorded by the quality of public financial management is the level of same at the start of the period in question: the countries with public financial management of mediocre quality at the outset are the ones that most frequently record improvements.

With regard to the impact of aid on improving public financial management, Fritz et al. find as a result of their analyses that it is not statistically significant. But unlike de Renzio, rather than using the volume of aid targeting public financial management as an aid indicator, they used the total aid expressed as a percentage of the GDP of assisted countries. It is not surprising, therefore, that such a non specific indicator does not produce conclusive results.

The evaluations

Another source of information on the evolution of the quality of public financial management in developing countries and on the possible role of aid in the improvement of same can be found in the evaluations of projects and programmes and country evaluations.

In 2008, the World Bank evaluation unit carried out an evaluation of the Bank's interventions supporting public sector reforms[24]. This report focuses considerable attention on interventions relating to public financial management.

The evaluators claim that two thirds of the countries which obtained a World Bank loan for reforming their public financial management system recorded an improvement in their CPIA. They also mention that, among the loans for reforming the public sector taken into consideration in their case studies, public financial management is the domain in which positive results were most often recorded. Preparation of the budget and reporting, they found, are the domains which received the greatest attention from the Bank and where the best results were obtained, whereas relatively little attention was given to phases downstream of the expenditure cycle, such as public contracts and auditing.

The evaluation report also mentions that progress differed both from one country to another and according to different types of indicator. The results of Bank interventions would have been better, the evaluators consider, (i) if more thorough analysis had been done of the institutions and governance of the countries benefiting from the interventions[25], (ii) if greater attention had been paid to the basics of public financial management before recommending

24 World Bank (2008), op. cit

25 This observation raises questions about the quality of the diagnoses made by the Bank and consideration of these diagnoses when formulating projects.

the adoption of sophisticated public financial management tools, and (iii) if the Bank had supported local systems for awarding contracts rather than turning to project management units using their own procedures. The conditions were more effective when, rather than imposing specific measures, they related to the results of public financial management, leaving to the governments of the countries responsibility for taking the measures necessary for obtaining these results and calling on technical assistance from the Bank whenever necessary.

Examination of the 18 country evaluations conducted by ADE also reveals progress in the quality of public financial management produced or galvanised by European Union interventions, but also the often limited nature of this progress, and the occasional fragility of the results obtained and failings observed.

Morocco (evaluation of budget support 2005-2012) provides an example of success in which financial support, strategic dialogue during the elaboration of reform programmes and significant technical support contributed to significant improvements in public financial management and human resources, and enabled the introduction of the principles of performance and transparency, as well as fostering a positive dynamic of change and a new culture within public administration.

The evaluation of MEDA programmes 2000-2006 notes that the these contributed to accelerating and consolidating the reforms that they targeted, in particular, when the Commission closely monitored the implementation of the reforms and conducted continuous political dialogue with the authorities and other donors. It also highlighted the fact that EU interventions were all the more effective when they supported reforms that governments were determined to implement.

Starting with public financial management of very mediocre quality, EU intervention in Togo helped to put the basics in place for healthier management of public finances and was the driving force behind major reforms in the award of contracts and control of public expenditure.

Other interventions produced more mixed results.

For example, the Nicaragua evaluation 1998-2008 reports progress with the legal and regulatory framework relating to the Finance Law, the preparation of the budget, the involvement of parliament in examining the draft budget and procedures for the award of contracts as well as with a view to a medium term budgetary planning. But it also highlights chronic shortcomings in financing for the maintenance of public infrastructure and little progress in transparency, accountability and participation.

The budget support given to Tanzania between 2005 and 2011 contributed to improvements in tax collection, the award of contracts and external auditing. But weaknesses detected by PEFA diagnostic analysis in the key domains of budget formulation, its performance, and the recording of expenditure were not corrected, while financial risks related to off-budget institutions continued to worsen. The evaluation mentions that this situation can be explained in part at least by the lack of technical assistance supplied in addition to the budget support.

In Burundi (evaluation 2012-2015), the performance indicators taken into account in budget support and technical assistance programmes created incentives for reforming the legal framework of public finances and contributed to better management of the treasury and progress in terms of transparency. But these programmes did not even promote adequate sequencing of the reforms or enable better coordination of donors.

The fragility of the results obtained can be illustrated by the case of Honduras. Whereas major progress had been recorded between 2003 and 2007 in terms of programming, recording, accountancy and control of expenditure, as well as the centralisation of resources in a single Treasury account, the situation deteriorated very considerably between 2007 and 2009 to the point that a number of donors suspended their budget support programmes.

Finally, EU interventions aimed at encouraging public financial management reform led to failure in some countries.

The evaluation of cooperation with Lesotho (2008-2013) mentions that the effects of the budget support programme on budgetary programming capacities and government performance, and more broadly on the improvement of public financial management, were very severely limited by general weaknesses in the public administration and political leadership.

In El Salvador (evaluation 1998-2008), where the reform of public financial management had begun long before the EU intervened, its intervention, according to the evaluators, made no significant contribution.

In Ethiopia (evaluation 1996-2003) attempts to link technical assistance projects targeting public financial management with budgetary support produced no notable result in the opinion of the evaluators.

5. **What are the effects of improving economic governance?**

The facts set forth in the previous chapter indicate that aid to development contributes, albeit unevenly and without always preventing failures, to an improvement in the quality of public financial management in countries receiving international aid. It is implicit in the evaluations that the most significant progress is made in countries where the objectives pursued by donors count on the strong political will of the government or, better still, when donors place their capacities at the service of reform programmes proposed by the governments themselves.

Nonetheless, the information available does not tell us whether the direct effects expected from this improvement of public financial management systems actually materialise, whether fiscal discipline is better guaranteed, whether the allocation of resources reflects the priorities of the stated strategies, whether public money is spent diligently and whether the efficiency of public spending is increasing or whether the governments are held accountable to the citizens for their strategic choices and the use they make of public funds.

It tells us even less about whether, assuming that these direct effects are obtained, greater growth is brought about and the fruits of this growth are distributed, leading to a reduction in poverty.

With regard to the direct effects of the improvement of the quality of public financial management, two attempts were made to understand them through econometric analysis.

<u>The econometric approach reveals direct positive effects of improving public financial management</u>

The study by V. Fritz, S. Sweet and M. Verhoeven, mentioned in the preceding chapter on account of its analyses of the determining factors of the quality of public financial management, also addressed the matter of the direct effects of improving public financial management.

Relations were tested between, on the one hand, the variations in public financial management quality and, on the other, the size of the public deficit, budget credibility, the efficiency of sectoral allocation of resources, the technical efficiency of health expenditure and that of expenditure on education.

As indicated above, the public financial management quality indicator used in this study is the average of the PEFA scores relating to expenditure indicators.

The econometric analysis reveals no statistically significant relationship between the quality of public financial management and the primary deficit of the state expressed as a percentage of the GDP. All things considered, it is difficult to explain why there should be a relationship between them; once public debt is sustainable, the size of the deficit is a strategic variable of the economic policy that bears no relation to the way, good or bad, in which public expenditure is managed. Fiscal discipline requires ministries not to spend too much but, ideally, as much as the resources that are allocated to them in the budget; it does not mean that the budget will tend towards balance.

The budget credibility indicator used by Fritz et al. is PEFA indicator PI-1, which reflects differences at global level between expenditure approved and actual expenditure. The study concludes that there is a positive relationship between these two variables. However reassuring this result may be, it is hardly surprising that a general improvement in spending procedures should lead to a reduction in the difference between forecast and actual expenditure.

More interesting is the observation that a general improvement in public financial management is also accompanied by progress in terms of efficient sectoral allocation of resources. The indicator used for the latter is PEFA indicator PI-2, which compares the sectoral composition of expenditure between the initial budget and the budget implemented. The study concludes that a general improvement in spending procedures leads to a reduction in differences not only between the total of approved and implemented expenditure but also in the sectoral distribution of forecast and actual expenditure. In other words, if the budgetary resources were allocated among the sectors in compliance with the development strategy, the improvement of public financial management contributes to this initial choice being better respected in implementation of the budget.

The statistical tests relating to the technical efficiency of public expenditure in the health and education sectors are potentially the most interesting. The indicators used for these two variables were obtained by linking the key outputs of these two sectors (life expectancy at birth and rate of completion of primary schooling) to public expenditure per capita and by estimating the technical efficiency by a stochastic frontier model. These tests, once the GDP is taken into account, did not, however, reveal any significant statistical relationship between the quality of public financial management and the technical efficiency of public expenditure in the two sectors considered. To explain this result, the authors suggest that many other factors besides the quality of public financial management, in particular the professional qualification of personnel working in these two sectors, affect the efficiency of public spending. One may also think, as regards health, that life expectancy at birth is an indicator whose evolution is too slow to expect it to be linked to the evolution over a number of years of the quality of public financial management.

Another study, by Francesco Grigoli, Zachary Mills, Marijn Verhoeven, and Razvan Vlaicu[26], sought to analyse the direct effects on the budgetary management of the implementation of a medium term expenditure framework.

The authors draw a distinction between three types of MTEF depending on whether they are limited to a projection of the single envelope of resources (Medium Term Expenditure Framework [MTBF]), take into consideration the distribution of resources between sectors and/or programmes (Medium Term Budget Framework [MTBF]), or associate budgetary forecasting with sectoral performance objectives (Medium Term Performance Framework [MTPF]). Their study is based on a sample of 181 countries and the period 1990-2008.

The authors conclude that (i) the elaboration of a MTEF and especially a more evolved form of medium term expenditure framework improves budgetary discipline and (ii) that a MTBF or a MTPF would reduce the interannual volatility of expenditure per capita in the health sector. One interesting finding, and one which some may deem counter-intuitive, is that these results persist when developed countries are removed from the sample. Accordingly, developing countries and transition countries, and not only countries that already have good quality public

26 Grigoli F., Mills Z., Verhoeven M, Vlaicu R., MTEFs and Fiscal Performance: Panel Data Evidence, World Bank, Policy Research Working Papers No. 6186, September 2012

financial management, can improve the performance of their public financial management through the implementation of a MTEF.

On the other hand, regarding the efficiency of expenditure, reflected by the same method as the Fritz et al. study on the example of health expenditure, the results of the study are not conclusive.

Open questions

Not having found an answer to the questions that we posed above on the contribution of an improvement in economic governance to growth and the reduction of poverty, the option remains of calling on the expertise of economists and practitioners long engaged in aid for development who we know are able to step sufficiently far back to identify the lessons that can be learned from this.

The questions on which we would wish to hear what they have to say can be put as follows:

- In the light of experience, is supporting development through the institutions of economic governance still a wise choice, or even a preferred entryway for aid to future development?
- Might other forms of aid, targeting private stakeholders rather than state stakeholders or reaffirming the role of the driving force of donors through recourse to common funds or even conventional projects, become possible alternatives?
- All things considered, is the reinforcement of institutions, when this occurs, mainly a response to the demands of donors or the real driving force of a national development project appropriated by the population?
- If it is a necessary but insufficient condition, what additional efforts are required? Have they been sufficiently taken into account?