(Re)Building Core Government Functions in Fragile and Conflict Affected Settings

Joint Principles for Assessing Key Issues and Priorities

3. Public Finance: Revenue and Expenditure Management
Disclaimer

This redacted and revised version of “Rebuilding Core Government Functions in Fragile and Conflict Affected Settings” is an Exposure Draft being released for public interest and consideration. The thinking on core government functions is continuing to evolve, and this paper is one of several efforts at engaging on this topic. The principles and guidelines explored here will be tested over the next few years, and a revised version will be produced subsequently in light of the lessons learned. It does not reflect the views and opinions of the World Bank Group or its Board of Directors, nor of the United Nations.
Preface

This report forms part of a response to growing calls for the United Nations, the World Bank and the International Monetary Fund to engage more systematically and coherently in fragile and conflict-affected contexts and indeed in major crises affecting security and development. In 2013, the Secretary-General’s Policy Committee called on these institutions to develop a joint approach and methodology to assess needs and improve the provision of support to core government functions in the immediate aftermath of conflict. This was echoed recently by the High-Level Independent Panel on Peace Operations in 2015 and falls within the scope of the Partnership Framework Agreement for Crisis-Affected Situations signed in April 2017 by the UN Secretary General and the WB President.

In the immediate aftermath of conflict, understood as the first three years after the cessation of widespread violence, the short-term objectives of assistance are usually focused on stabilization: to provide a minimum level of security, set in motion the beginning of an economic recovery and lay the initial foundation for long-term institutional development. The importance of restoring core government functions has been repeatedly identified as critical to sending confidence-raising signals to the population in the aftermath of conflict, to both project the authority of the state and for the delivery of services that improve development outcomes.

The lessons learned over the past decade emphasize the importance of incorporating a political economy approach to building core government functions, the need for flexibility and adaptation to changing political and security circumstances, the management of risk and the importance of staying the course in the face of crises and temporary reversals. Rather than adopting comprehensive reforms or entirely new business processes, it is about building on existing institutional legacies, adapting existing systems and working in an incremental manner. Tradeoffs between introducing the basic building blocks of public financial management, and understanding the need to distribute rents that create stability will need to be recognized and addressed. A key requirement for a durable recovery is a political settlement that is sufficiently inclusive of the major elite coalitions with the capacity to mobilize organized violence. Partnerships between the United Nations and the World Bank can enable greater flexibility in providing support, through enhancing the areas where one partner has a comparative advantage, whether it be geographical access, depth of technical expertise or an explicitly political mandate.
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Chapter 3. Public Finance: Revenue and Expenditure Management

3.1 Objective

In an immediate post-conflict situation, establishing the following core finance functions are paramount: (1) identifying potential resources and taking steps for mobilization, (2) safeguarding resources until they can be applied to priorities, (3) assuring resources get to their intended purpose. Needs will generally outweigh available resources, so these basic functions need to be put in place quickly. “Systems” can be developed over time. Each basic functionality will look different, depending on initial conditions - there may be no currency, no laws, little capacity, and the economy may have reverted to subsistence and barter. There may be no legislature, little government bureaucracy, and no formal processes in place.

3.2 Public finance in a post-conflict setting

Establishing basic structures and systems of public financial management (PFM) is critical. In addressing PFM, several broad generalizations can be made.

First, identify existing economic resources and assets that can be mobilized immediately.

Second, public finance decisions must support the political settlement, consolidation of security, and providing basic goods and services to the most vulnerable citizens (such as food, shelter, medical care, and clothing). This requires a close dialogue between government and donor agencies, as well as the local entities and international organizations responsible for helping support a durable political settlement and restoration of order and security. This also calls for an unusual degree of inventiveness and sensitivity in implementing revenue mobilization measures and expenditure programs - while at the same time respecting the well-established principles of good fiscal and expenditure management.

Third, some corruption or leakage is initially unavoidable. It is important to recognize that corruption may not be fought across the board, and that priority ought to be given to fighting the forms of corruption that undermine the trust of citizens in the state. When resources must be allocated to powerful individuals or groups, the allocation should be recorded and be made.

Fourth, despite the inevitable compromises, revenue and expenditure policy and management should be broadly consistent with a vision owned by the government and supported by the donors. This does not require a full-fledged development plan. However, a general sense of economic and financial direction is mandatory, and must flow from a genuine dialogue between the new government and the main donors.

Finally, a formal and public budget, even if rudimentary, is essential in order to reflect the financial implications of the reconstruction program; signal basic policy directions; make clear and transparent the intergroup and interregional resource allocation; create a process through which the practice of open debate and the habits of peaceful compromise can begin to be rebuilt; and as vehicle for government-donors dialogue.
3.3 Principles

Following on these generalizations are several guiding principles for the introduction of an orderly budget process in the early post conflict period:

- **Selectivity and gradualism.** Owing to the low-information, high-uncertainty environment, trying to enact too many PFM reforms at once can risk backlash and institutional loss of credibility.

- **Maximum simplicity.** The limited capacity precludes the introduction of complex budgeting practices, and simple systems are more conducive to transparency.

- **Combination of pragmatism and efficiency.** The choice of systemic public finance and institution-building measures should be largely dictated by conditions on the ground, but must also be consistent with good practice lest state fragility be perpetuated.

- **Transitional means transitional.** When the situation demands emergency fiscal, procurement and financial management measures that may not necessarily be consistent with strengthening country systems (such as project implementation units, fiduciary agents and others), these measures should be designed and accepted as strictly transitional, and a robust mechanism must be put in place to assure that they lapse after they have served their emergency purpose.

3.4 Priorities

3.4.1 Legal and Organizational

The following priority actions apply at the start of the post-conflict period. In very low-capacity countries, they may entail creation of new entities or promulgation of new rules:

- **Review the organizational legacy.** Nearly all post-conflict countries had fiscal and public financial organizations prior to the conflict. Using this legacy as the starting platform helps rebuild the organizations and reduces the need for changes. Public financial management can thrive in more orderly environments.

- **Selectively and rapidly examine the legal and regulatory framework** for PFM. Revisions, if any, should be targeted and limited, with tax and customs legislation and regulations taking priority, unless passing a new PFM law is an important element to rebuild state legitimacy and symbolize the authorities’ desire to break with non-transparent practices of the past.

- **Create a central public finance authority or strengthen the surviving one.** A critical requirement is to have a functioning entity with the capacity to lead for the government in all public finance and planning matters. Regardless of the specific organizational structure, the establishment of the central PFM authority should seek to: prevent ad-hoc fiscal decision-making; establish fiscal transparency; and align government spending with country priorities.

- **Establish and strengthen the revenue agency:** put in place the basic physical infrastructure for the tax administration; appoint key staff; establish registration and taxpayer identification; and set up basic filing and payment procedures.
• **Establish or restore the supreme audit institution**: it is fundamental to embed in the government and the public the notion that without independent external audit, neither short-term stability nor progress toward sound public financial governance can be expected. This also means that the early production of financial statements, even if they have limits, would be important to start the chain of accountability.

• **A medium-term fiscal perspective** is important even when capacity is extremely limited. However rudimentary and tentative, such perspective can provide the underpinning for donor pledges over a period of several years, thus improving the predictability of aid and the timing of disbursements with increases in local absorptive capacity. However, going to a full-fledged Medium Term Expenditure Framework (MTEF) is probably over-ambitious in a low capacity, fragile context.

3.4.2 Revenue Priorities
On the government side, the following are likely priorities for the immediate post-conflict period:

• **Rely on taxes suited to the limited capacity and conditions on the ground.** Indirect taxes, (especially customs), although they may be regressive, are the most feasible source of early revenue.

• **Prevent the growth of tax exemptions and limit fraud and evasion**, particularly in customs.

• Where extractive resources are important, **establish sound governance and monitoring systems, and strengthen the government in its interaction with multinational corporations.**

• **Do not view extractive revenues as a substitute for taxes.** Even when the government obtains sufficient revenues from natural resources, domestic taxes are necessary to counteract the tendency of extractive resource revenues to crowd out institution building, and to restore the citizen-state compact - “no representation without taxation.”

On the donors’ side, priorities include:

• **Investing in revenue mobilization** could have high returns in terms of the integrity, efficiency and macroeconomic prospects of post-conflict countries. Actively support efforts at levelling the playing field between extractive resource countries and corporations, while insisting on sound in-country governance of natural resources.

• **Be more transparent** about their own aid practices and associated tax exemptions, and avoid practices that distort the pattern and efficiency of government fiscal operations.

3.4.3 Expenditure Management Priorities
Given the special risks in post-conflict countries, expenditure control is a key requirement. In countries of very limited capacity, two priorities are to introduce simple basic mechanisms to effect and control payments, as well as to manage government cash prudently. Four more general budget preparation priorities are:

• **Prepare various budget scenarios and formulate an orderly procedure for frequent in-year budget amendments.** Single scenarios are not compatible with the uncertainties of the immediate post-conflict period. However, the scenarios should be kept simple and at a relatively high level of aggregation. At the same time, without a clear and agreed procedure for amending the budget, erratic, uncontrolled and opaque changes can compromise the credibility of the initial budget itself and provide corruption opportunities.
• **Initiate selected efforts for budgeting capacity in the major line ministries**, and gradually scale-up to other ministries.

• **Establish a simple and practical system for collection and dissemination of financial information**: this could mean restoring the functionality of the legacy Financial Management Information System (FMIS), or quickly establishing a simple, off-the-shelf FMIS. This is important to ensure data integrity and the existence of an audit trail, which cannot be guaranteed by using simple spreadsheets.

• **Put in place procedures for legislative consideration and approval of the budget.** The initial quality of the legislative debate is likely to be low, but the habits of formal legislative consideration and timely approval should be established early.

For budgeting current expenditure, four measures are priority in most cases:

• Carefully review the wage bill to protect against deliberate misclassification of personnel expenditure, duplicates and uncontrolled hiring.

• Carefully review operations and maintenance (O&M) expenditure, to see that such spending takes account of the actual state of the government’s assets.

• A fresh assessment is needed of whether a major government asset remains sufficiently valuable to warrant the allocation of budgetary resources for its maintenance, or has been so degraded by the conflict and prolonged deferred maintenance as to be best sold off or abandoned.

• Assure that subsidies and other transfers are based on adequate legal authority and, above all, are clear and public - even if, indeed especially if, such criteria are in part political.

Decisions regarding investment expenditure should be consistent with the general direction of the reconstruction and recovery program, as well as the need to support the political settlement. Major individual projects are usually designed by or in association with donors, and implementation is normally entrusted to special project implementation units. However, it is important to begin to build the government investment project preparation capacity, and thus to:

• Conduct a rapid review of the incomplete investment projects launched before the conflict. Decide which should be discontinued - placing the burden of proof on restarting a project. Empower a group at the centre of government with responsibility for oversight of the project execution process.

• Establish a small investment preparation/clearance unit.

• Begin to formulate good-practice rules of investment programming and project appraisal and selection; and move away from “emergency” modalities as soon as it becomes feasible.

• Formulate an action plan to gradually strengthen the capacity of the major line ministries to formulate investment proposals and execute projects.

• Put in place early safeguards to prevent the emergence of enclave-type arrangements whereby a donor agrees with a ministry on investments in the sector but without reference to the overall reconstruction program or
development and fiscal sustainability objectives.

- Selectively open initial channels of systematic feedback from civil society on investment needs and project implementation (as and when security and other circumstances permit).

- Think early on about a strategy to develop a cadre of qualified procurement officers who understand both strategic dimensions of procurement and processing aspects.

Investment is the category of expenditure where the risks and the opportunities for supporting a durable political settlement are especially high. Investment priorities are determined differently from a stable country, where most projects are normally appraised based on economic criteria. This reality does not at all imply a free-for-all abandonment of investment rules and criteria, but does require making distinctions between projects that must be identified and executed under special modalities suitable to their political/social objectives; other projects tailored to humanitarian or damage-control goals; and still other projects that must meet the standard rules of economic appraisal, readiness for implementation, monitoring, execution and evaluation. In the latter case, the perfect projects (through exact cost benefit analysis) should not prevent projects that are good (those with likely positive present values, even where there may be high uncertainty in estimation).

For special post-conflict expenditure programs targeted to the needs of particular groups - internally displaced persons, child soldiers, and victims of gender-based violence - evaluation on economic grounds is neither possible nor appropriate. However, budgeting for these special programs should still meet certain standards, particularly: correct identification of the beneficiaries; estimate of expenditures on the basis of the actual activities envisaged; costs broadly consistent with prior experience in similar cases; and adequate monitoring and reasonable accountability for outcomes.

The design and implementation of budget execution modalities should be simple and encourage a culture of oversight, integrity and accountability. The first objective is to foster compliance with the approved budget (i.e. to improve fiscal marksmanship). Other objectives are adaptability and predictability of disbursements. To achieve these three objectives, priority areas are:

- As soon as possible, replace in-kind and cash payments with payments by check or leapfrog to wire transfers/mobile money. This will close off easy corruption opportunities and foster growth of retail banking, particularly in underserved regions.

- Set up a mixed system of centralized and decentralized payments. The appropriate mix will depend on regions’ physical security, transport, communication and banking service conditions.

- In cash management, gradually migrate to a treasury single account, as conditions permit and the political and security situation allows.

- Introduce controls at each of the three stages of expenditure after authorization (commitment, verification, and payment). These controls can be directly administered by the ministry of finance, but not for decentralized payments where the paying agent needs to administer them. Later, progressively greater reliance can be placed on internal controls in the line ministries themselves.
• Introduce an internal inspection or audit function in the largest spending ministries. It would be important to rapidly introduce the concept of risk-based internal audit, while building on existing internal oversight bodies (rather than creating new entities).

• Establish a simple cash-based bookkeeping system, preferably based on double entry principles. The reliability and timeliness of accounts are more important than the basis of accounting. Furthermore, the lack of data and limited supply of public accountants typical of the aftermath of violent conflict makes it unrealistic to adopt anything more demanding than bookkeeping. Depending on the level of income of the economy, the capacity in the country and the need for accrual information for management purposes, the transition to accrual can be thought through from the outset.

• Assure regular financial reports on budget execution, equally simple, but issued on a schedule and made public at the earliest practicable time.

• Assure periodic reports on the physical execution of large investment projects, with strong oversight by the planning entity and with assistance by independent expertise.

• Prepare a strategy to develop the government’s own procurement and financial management capacity consistent with established good practice. Procurement and financial management procedures need to be applied with the hands-on support and flexibility required to produce timely results, while ensuring that funds are used for their intended purposes, with due regard to economy and efficiency.
Annex: Diagnostic Questions

A.3 Public Finance: Revenue and Expenditure Management

Legislative framework and capacity issues
- What key elements of the legal and regulatory framework for revenue and expenditure management are missing?
- Does a central tax authority exist, and is it functioning? What is needed as the basis for adequate tax collection capability beyond the immediate post-conflict period?
- Does a central public financial management authority exist, and is it functioning? Which parts need strengthening to ensure strong expenditure control and minimally adequate allocation and use?
- Is there a dedicated unit for preparing and proposing government investment projects?
- Have key staff members been appointed in the revenue and expenditure management agencies?
- When and how can plans be put in place for strengthening line ministries capacity, especially for investment project preparation, procurement and financial management?

Revenue
- What is the current structure of the tax system? How do rates compare to neighboring countries?
- Are extractive revenues important? If so, what provisions can be put in place for sound governance to protect the resources and allocate them appropriately?
- What is the extent of exemptions and allowances, in particular in indirect taxes?
- What is the state of the customs agency, in terms of integrity and efficiency, and what plans can be made to strengthen it? What is the state of taxpayer registration and identification?

Budget preparation
- Does a formal budget process exist, even if simple? What types of public spending are not included, if any?
- Is a medium-term macro-fiscal forecast in place, even if aggregate and tentative at first?
- Are aid funds integrated in the budget?
- Is a preliminary budget calendar available?
- Are there procedures for beginning to involve the legislature in the budget approval process?
- Do adequate provisions exist for cooperation between the finance and the planning functions, whether located in a single ministry or separate ones?
• How is proposed capital spending integrated into the budget?

• Is there an agreed approach for selecting a few of the “legacy projects” for completion and for the orderly disposition of the others?

• Are large personnel expenditure misclassified as investment?

• Are budgeted expenditures for O&M adequate to assure initial operational requirements?

**Budget execution**

• Are minimally effective controls in place at the commitment, verification and payment stages? Are these controls implemented centrally by the ministry of finance or decentralized to line ministries and agencies?

• How are payments for wages, contracts and other purposes implemented? What approximate proportion of government payments are made in cash?

• How quickly can cash payments be phased out?

• How does the government manage its cash? Are all government bank accounts under the control of a central authority?

• What procedures exist for amending the budget?

• How and when can effective wage bill controls be introduced in the Ministry of Finance?

**Monitoring, accounting and reporting**

• Is a basic system for collection and reporting of financial information in place?

• Is there a reliable accounting system - even if initially simple single-entry bookkeeping?

• Is there a reliable schedule for financial reports on budget execution, including on the financial implementation of investment projects?

• How and when can a system for reporting on the physical execution of investment projects be put in place?

• What provisions can be quickly put in place to make key budget information public in understandable formats?

**External audit**

• What is the state of the existing Supreme Audit Institution (SAI)?

• How and when can it be strengthened sufficiently to exercise its external audit function (even if specific audits may need to be contracted out)?
• How quickly can the International Organization of Supreme Audit Institutions (INTOSAI) become involved into assisting the development of external audit?

• Are there possibilities for twinning with another country SAI?