Policy Brief 3

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Enhancing the Capabilities of Central Finance Agencies: A Political Economy Perspective

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Key points

- Political economy analysis can provide operationally useful insights for improving the strength of Central Finance Agencies (CFAs).
- A political economy approach places critical focus on CFA capabilities, offering a much needed avenue for public financial reform and CFA strengthening.

Central Finance Agencies (CFAs)[1] are uniquely positioned, strategically and operationally, to influence economic outcomes (see Commission on Growth and Development 2008). As the agency in control of public resources, a CFA marshals and deploys resources to achieve desired objectives and outcomes while at the same time also exercising guardianship over the public purse through its institutional roles, provision of incentives, and administrative culture (Wanna et al 2003). Combined with numerous other functions (core and noncore), CFAs are thus assigned predominant responsibility for the shaping of resource decisions and supervision of public finances[2]. Moreover, as the the "nerve center" of government, CFAs are central to reform itself; often their power and leadership critically determines the scope and content of the reform process (Scott 2008).

However, efforts to enhance the role and functioning of CFA's in many low and middle income countries have been mixed (IEG Report 2008). In some cases, CFAs have become truly transformative agents of change, providing critical leadership for a wide array of Public Financial Management (PFM) reforms that have had far-reaching effects on macroeconomic stability and the efficiency of resource allocation, and thus on growth and poverty reduction. In other cases, they have either failed to assume a transformative role or failed to sustain it. Instead, to the detriment of economic outcomes, CFAs have often been ill-configured and have had unclear and conflicting mandates and lines of accountability. Their effectiveness has also been hampered by capacity problems in areas such as human resources, accounting and budgeting, and information technology. What explains these very different outcomes? And how do we go about strengthening CFAs?

1. CFAs are core ministries for managing public finances, alone or in combination. Terminology and organizational structures differ across countries: Some countries use the term 'Treasury,' others 'Department of Finance' or 'Ministry of Finance.' Organizational structures also tend to differ. Some countries opt for a single super-ministry responsible for finance, economy, planning, and industrial policy; many others scatter accountability for fiscal and economic management among ministries (i.e. MOF and MOE). There is also the option to separate the Ministry of Finance from the budgeting function. Hence, the term 'central finance agency' is used as an encompassing label to describe the core ministry for managing public finances (whether single or in multiple combinations).
2. For the sake of simplicity, 16 core functions can be identified, including: macroeconomic forecasting and analysis; tax policy; budget preparation and analysis; public investment management; aid and debt management; financial assets and liabilities; intergovernmental fiscal relations; treasury and cash management; accounting and reporting; internal audit; public procurement; civil service pay; financial sector regulations; financial framework for managing State-Owned Enterprises (SOEs); tax revenues and customs administration; public financial (PFM) reform coordination.

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We undertake analysis and promote discussion on aid and development, with a focus on Australia, the Pacific and Asia.

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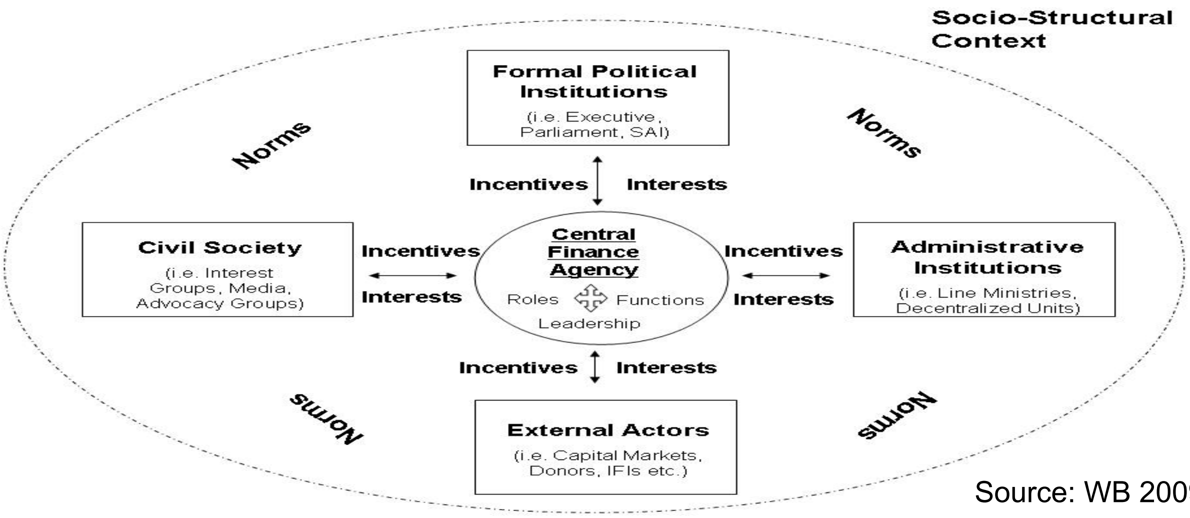
Figure 1: The Political Economy Context of CFAs



Source: WB 2009

Drawing on debates of problem-driven governance and political economy analysis (see Fritz et al 2009) and based on the findings from a recent World Bank study of CFAs in low income countries, we find good reason to move away from a purely technical view on PFM matters to a more distinct political economy view. Such a view shifts the debate away from the current paradigm of capacity building to a more distinct focus on 'capabilities' and, in doing so, accounts for the embedded nature of a CFA in the political, economic and structural context of a country. This view promises to open up new avenues for current efforts to strengthen CFAs by providing a set of reforms that are a 'good fit' for a given context, and thus able to rely on country ownership.

Towards a Political Economy Framework of CFA Strengthening

Governance and Political Economy Analysis has gained increasing attention in the wider development community over the last decade (see DFID 2006; OECD 2010; SIDA 2005), though its operational application to the sector and project level - particularly in areas such as PFM - has remained limited (Hedger et al 2007). Recent debates around problem-driven governance and political economy analysis (WB 2009) seek to address these shortcomings by urging a more problem oriented approach that would take an existing problem or vulnerability as a start before 'drilling down' on issues by (1) mapping out major institutional arrangements (i.e. institutions, laws, policy processes, etc.) and (2) identifying its underlying political economy drivers (i.e. actors, incentives, structural constraints) to understand the nature of the current situation and derive a set of remedies that are fitting and feasible within the current context (see WB 2011).

Applied to the aforementioned context of strengthening CFAs, the implication of such an approach is twofold:

First, when it comes to understanding existing vulnerabilities in CFA functioning, it is helpful to move away from the current focus on "capacity" to a new analytical focus on "capabilities". Capacity and capability are at times used interchangeably, but they are clearly distinguishable: the former refers to the volume or scope of CFA inputs of an appropriate quality (determined, for example, by the IT or human resource base), while the latter is about converting that volume into performance. To be sure, the two are linked: where capacity is low, capabilities are also likely to be constrained. And yet, a weak configuration and/or organization of inputs and a high-cost operating environment, perhaps marked by a lack of authority, may mean that even when capacity is high, capability may be low.

Conversely, there may be cases where a CFA has low capacity, but scarce resources have been put to effective use due to a supportive operating environment, thus creating considerable capabilities. In short, thinking about CFA strengthening requires first and foremost an analytical focus on capability rather than capacity because it is the latter that ultimately determines the role and effectiveness of a CFA in the PFM process.

Second, seeking to enhance the capabilities of a CFA requires political economy analysis to be brought to the fore. This involves a careful mapping of the key interfaces of a CFA with the wider institutional realm – including the formal political institutions; administrative institutions; civil society; external actors (i.e. donors, IFIs, capital markets) – as well as within the CFA itself. Combined with the broader socio-structural context that provides the boundaries for these institutional dynamics to unfold, such a view allows us to clearly understand the political economy dynamics that shape the functioning, and ultimately the capabilities of, a CFA in respective areas of public financial management (figure 1).

As this framework clearly indicates, strengthening capabilities is a complex endeavor. The capabilities that a CFA can bring to bear are not simply determined by existing technical capacities or resources, but rather best understood as the outcome of the complex interplay between institutions, actors and structural constraints (Stevens 2004; von Hagen 2005). It is precisely for this reason that a political economy approach is so valuable – it recognizes and clarifies these complex external dynamics, while at the same time drawing attention to traditionally neglected internal factors, such as the culture, morale and incentives of the organization; the quality and experience of its management and staff; the organizational structure; and the business processes that underpin the organization and its information and human resource management system. In short, in providing a contextual and dynamic understanding of capability issues, a political economy approach is critical to the goal of CFA strengthening.

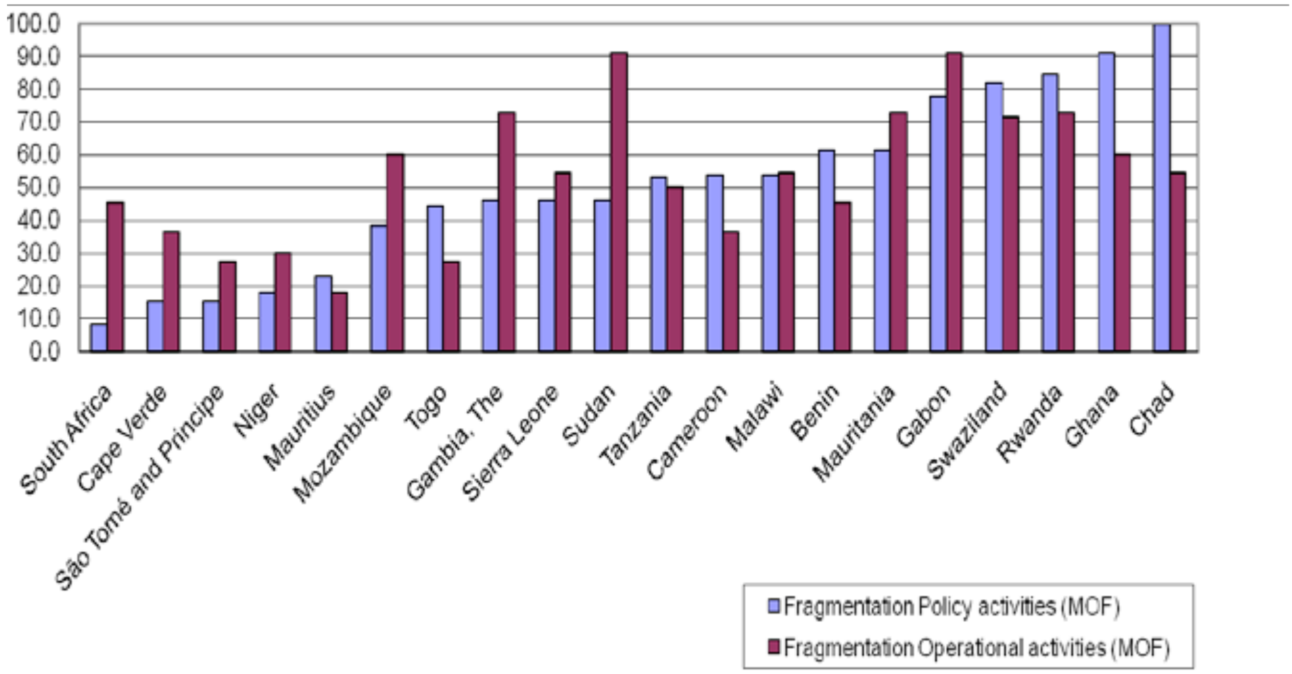
The World Bank CFA Study: Some Preliminary Findings

Guided by these broader theoretical assumptions, in 2008 the World Bank launched an explorative study of CFAs. It combined a set of in-depth case studies of CFAs in low income countries (six in Sub-Saharan Africa; two in East Asia Pacific, and two in Latin America) with the creation of a database (of currently 55 countries) containing information on organizational structures, staffing, and ICT systems. The full findings of the study are captured elsewhere (WB 2011), yet a few points might be highlighted here.

As far as the CFA data collection effort is concerned, the database has highlighted a number of interesting patterns, including:

- the wide variation in practices from country to country, including: functional fragmentation (despite CFA activities mostly being carried out by the central finance ministry itself); staffing numbers (the average size of an MOF is 1,100); gender (female managers representing less than 4 percent of the sample) and ICT use (with 67 percent having some form of internet or knowledge exchange);
- the tendency of policy functions to remain within the MOF, while operational functions (i.e. revenue collection, PIM etc) are often devolved to subordinate agencies and/or line ministries;
- a broader U-curve pattern, whereby in middle income countries fragmentation tends to decrease as finance functions are consolidated within central MOF, but increases as countries develop further (as automation of routine operations and capabilities of line ministries grow);
- the trend that resource-rich countries are more prone to fragmentation (as other actors –energy ministry, national petroleum company – become powerful sources of financial influence), while fragile states are often less fragmented, given the unique opportunity to consolidate fiscal functions due to the emergency status of public finances, donor pressure and fragility of political claimants.

Figure 2: Operational and Policy Fragmentation (Sub-Saharan Africa sample)



The (sub) sample from Sub-Saharan Africa (see figure 2) is a good illustration of this. It not only shows a wide variation in patterns of fragmentation, but also the distinct differences in operational and policy fragmentation across countries from the region.

In terms of some of the qualitative findings from CFAs in selected countries, the study also highlighted several distinct political economy aspects that interfere with the capabilities of CFAs, including:

- The use (and misuse) of presidential power (i.e. considerable interference of the executive in budget planning and execution, as well as distribution of material benefits such as rents through informal channels outside the control of the MOF);
- Fragmenting the CFAs for political gain (i.e. the deliberate fragmentation of CFA functions as part of a 'divide and rule' strategy aimed at serving political purposes, such as distribution of rents, accommodation of a transitional compact, etc.);
- Internal constraints of CFAs (i.e. erosion of bureaucratic capacity due to persistence of informal structures that interfere with recruitment and performance systems);
- Donor coordination of CFA reforms (i.e. dysfunctionalities brought in by a lack of donor coordination or bidding up and slicing of programs).

While reflecting the rather complex picture that emerged from the case studies, these points provide interesting connections with recent studies that have sought to expand the understanding of weaknesses in efforts to reform existing PFM systems from a broader theoretical and empirical perspective (Andrews 2009; de Renzio 2011), though clearly more work is required here.

Operational Implications

The findings of the WB study illustrate how highly relevant political economy analysis is to the design and implementation of new initiatives to strengthen CFAs and their capabilities. A broader political economy analysis not only provides an understanding of existing vulnerabilities and bottlenecks in CFA operations, but also helps to clarify the prioritization and sequencing of CFA and PFM reform. It also facilitates the aim of fostering a greater CFA role in the country-wide development trajectory. That said, such analysis requires time and resources and in many ways requires new modes of engagement for CFA staff as well as donors.

Indeed two distinct implications might be drawn for these respective groups. For instance, CFA staff should consider:

- Using political economy analysis to better understand the drivers and dynamics of the CFA/PFM reform process. Specifically: where there is a dynamic reform environment, focus on what can be done within the limits of the PE constraints (rather than attempting reforms to please the donor community); where there is a stagnant reform environment, try and build partnerships with groups that can exert effective pressure on governments to reform – whether civil society, reform-oriented political actors, or external oversight agencies, such as supreme audit institutions;
- Focus on the mobilization of internal 'capabilities' before seeking donor support in capacity building. This would include efforts to optimize internal workflow and resource use; strengthen routes of accountability and transparency mechanisms; emphasize leadership from within; clarify and consolidate engagement with donors;
- Have realistic expectations. CFA transformation takes time, is often incremental, and is hardly a linear process. Much will ultimately depend on the ability to combine technical excellence with that of building and sustaining reform coalitions.

Likewise, external actors should make use of political economy analysis as a filter before launching lending projects, and during their preparation and implementation. Moreover, a political economy approach would urge external actors to:

- Invest in the development of a continuing dialogue with political leaders and other stakeholders who can be instrumental in driving the reform effort;
- Refocus CFA reform strategies on "best fit" solutions rather than "best practice" models;
- Provide more intensive advice to clients on change management practices, and efficient project management; and
- Review the HRM policies (including policies on rotation) in respective agencies to develop deep country and stakeholder knowledge of political economy aspects of reform.

In sum, applying political economy analysis in this manner means a very different mode of operation, one that is critical when seeking to enhance the capabilities of CFAs.

Moving Forward: Open Questions & Debate

These are only the initial contours of a more distinct political economy approach to strengthening the capabilities of CFAs. More thinking is still required. For instance, as highlighted in discussions during the CABRI 2011 workshop, it is important to further qualify the characteristics of "capabilities" vs. "capacities", perhaps by linking the former more clearly to the organizational literature[3]. Similarly further research is required on the issue of functional fragmentation, not just among agencies but also within a particular ministry – only partially covered by the above mentioned WB study. Indeed fragmentation (policy or operational) of CFA functions might be manageable (or even desirable) as long as clear coordination and M&E systems are in place, though there seems to be agreement that such arrangements would require a lead agency for enforcement. Finally, more data collection regarding CFAs might be useful. This could support efforts to establish a basic baseline of CFA capabilities for future comparison while also strengthening linkages to existing PEFA indicators. This would start a more informed debate about how to enhance CFA capabilities and chart a reform trajectory of which ownership can be claimed and for which wider stakeholder support can be garnered.

Possibilities for further inquiry notwithstanding, there is little doubt that political economy analysis can provide operationally useful insights for CFA strengthening efforts. Providing a distinct toolkit of analysis and a critical focus on CFA capabilities, the approach offers a much needed avenue for PFM reform efforts and CFA strengthening.

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3. An interesting starting point here provides the literature on "dynamic capabilities" (see Pablo et al 2007)

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Policy Brief

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