Small isn’t always beautiful: how smallness undermines public financial management in the Pacific and what to do about it

By Tobias Haque, David Knight and Dinuk Jayasuriya

“Public financial management systems are the engine room of development” – Emilia Pires, Finance Minister, Timor-Leste.

Much attention is currently being paid to public financial management (PFM) in Pacific Island Countries (PICs). Improving systems for raising tax revenues, allocating resources between ministries and sectors, and achieving value for money through public expenditure is a stated priority of governments and donors across the region and most PIC governments now have some kind of PFM reform process in place. These processes are generally supported with enthusiasm by donors, who increasingly make use of country financial management systems in delivering aid.

But PFM reform is an arcane field, in which there is surprisingly little agreement as to appropriate models and the relative priorities of reform efforts. While PICs are often considered to have "weak" PFM systems, there is little analysis of how their systems differ from those in other developing countries. Few explanations for weakness have been presented beyond vague appeals to "culture" or "governance".

In our recently-published [World Bank Policy Research Working Paper], we use PEFA assessment scores (a standardised international scorecard for measuring the quality of various aspects of PFM systems) to empirically examine patterns in the PFM performance of PICs. We look at the performance of PICs relative to other countries and attempt to identify causes for their apparently weaker performance and find that:

- **Income and population size exert a significant influence on the PFM performance of all countries.** Smaller countries face a significant size penalty in PEFA scores. Taking account of differences in income, small countries have weaker PFM systems. Overall, the weaker performance of PICs can be entirely explained by their smaller population sizes once their levels of income are taken into account.
- **Population impacts on the PFM performance of small countries**

through the imposition of capacity constraints. The weaker performance of smaller countries is largely driven by problems in undertaking PFM functions that require specialised skills. Small countries with smaller public services (in absolute terms) find it harder to recruit and retain people with the appropriate skills. These capacity constraints are avoided by countries that have populations adequate to provide a critical mass of the required skills and resources. The lag in performance from capacity constraints associated with smallness seems to outweigh any potential benefits of smallness, such as a smaller number of administrative units, less spending through sub-national governments, or easier communication.
- **Population size exerts the most significant constraint on PFM functions that are technically specialised and need to be carried out beyond central agencies.** Available technical capacity in small countries is often concentrated within central agencies, which also typically benefit from external technical assistance to PFM processes and reforms. PFM functions that can be undertaken within these ministries are therefore performed better than technically-demanding functions that must be carried out at the level of line agencies. Smaller countries therefore lag furthest in the technically-demanding functions that are required outside of central agencies.

The primary lesson to be gained from our analysis is that the scope and ambition of PFM reform needs to be appropriately calibrated to the context of small PICs. PICs face fundamental disadvantages in implementing standard PFM systems because of inherent skill gaps. It is therefore unrealistic to expect them to successfully implement PFM systems employed in much larger countries at similar levels of income.

We identify three important implications of this analysis for governments and

donors involved in PFM reforms:

1. **Ensure that scarce capacity is prioritised towards the reforms that will have the greatest impact on the achievement of service delivery or other policy objectives.** If a country has, and is likely to continue to have, only a small pool of qualified accountants, lawyers, IT specialists, or individuals experienced in financial planning, then it is important that they are used where they can have the greatest impact, and sufficiently concentrated to achieve results. PFM reform efforts should be targeted toward the weaknesses in PFM systems that are exerting the greatest constraint on the achievement of broader development objectives.
2. **Examine the balance in external assistance between central and line agencies.** Donors tend to focus technical assistance support to PFM reform within central agencies. But the capacity constraints faced by small PICs have the greatest impact at the level of line agencies. The areas in which small PICs perform particularly weakly are unlikely to be well-addressed by technical assistance or PFM reform programs centered on Ministries of Finance. It may be useful to consider whether the achievement of particular reform objectives requires additional technical assistance and capacity building at the line agency level, where capacity constraints are most severe.
3. **Recognise the likely ongoing nature of capacity constraints and the need for capacity supplementation.** Small PICs lag behind other countries in PFM areas that require specialist capacities. These capacities are not easily built or retained. It may be necessary to consider options for accessing international capacity on a continuing basis if capacity constraints to achieving a priority policy objective in PFM are unlikely to be surmountable with local resources alone. While some capacities can undoubtedly be developed locally, others will need to be "imported" on a

continuous basis over the long term.

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