Combating corruption and public financial management

Introduction

Corruption has a highly damaging effect on many developing countries. In this **presentation**, we define corruption, provide examples of public sector corruption and examine its effects (and the costs). We look at the relationship between public financial management (PFM) and corruption and present actions to combat corruption. We also discuss the role of development partners in assisting PFM reforms.

International Development and the Challenge of Public Sector Corruption

By David Fellows, John Leonardo and Cornelia Körtl[1]

Revelations in the Panama Papers released earlier this month have focused international attention on the hidden financial structures that facilitate the transfer of assets obtained through both legal and criminal means to offshore tax havens. In a recent report, the research organization Global Financial Integrity suggests that illicit financial flows from developing countries have reached the staggering sum of $1 trillion a year.

Is corruption in developing countries of any legitimate concern to the West? The U.N. Economic Commission for Africa in its recent African Governance Report IV implicates the West when it suggests that "the role of private sector actors in fuelling corruption … should not be ignored." Yet Western nations are increasingly expected to act as trading partners to developing countries. They must also be accountable to their electorates for obtaining value from their aid expenditure.

Corruption concerns the use of public position to gain private advantage, such as wealth, power, or status. In the public sector, corruption can take on many forms, ranging from the misappropriation of funds to extortion and the abuse of patronage. We provide further examples here. It can reduce state revenues, increase state expenditures, diminish economic development, and impair the capacity of public services. It can also hamper the transition from aid as project-funding to aid as direct budget support. Corruption can undermine nationhood by destroying confidence in public administration and the political process, impoverishing communities and denying opportunity.

At the most recent OECD's Anti-Bribery Ministerial Meeting, the president of the International Federation of Accountants stressed the importance of strengthening public financial management (PFM) systems to combat corruption in the public sector. PFM includes budget preparation, internal control, internal audit, procurement, monitoring and reporting arrangements, and external audit[2].

In this short piece we offer evidence that corruption hampers government effectiveness, including the quality of public services, and economic prosperity. While serious corruption exists in both developed and developing countries, it is developing countries that can least afford the very significant cost and the collateral damage. We suggest that good PFM can help control corruption and we set out our thoughts on how this beneficial effect can be achieved.

Two sides to corruption

Worryingly, networks of corruption can normalize corrupt behaviour and offer mutual protection to those involved. In an insightful report on Indonesia in 2003[3] the World Bank stresses the importance of organisational environment over salary level and suggests that political corruption usually requires the active complicity of civil servants. The international Anti-Corruption Resource Centre, U4, has developed a useful account of the personal and social considerations in play. For instance, the risk of detection and consequent penalties can be equally relevant considerations: when the risk of detection is low, corruption may thrive even in situations with significant penalties. Contrarily, corruption may be high with high risk of detection but low penalties. Similarly, Khan[4] argues that the underlying distribution of power between actors is essential to understand corruption in a particular context. Clearly, anti-corruption reforms must address the specific drivers of corruption in the national context.

Various international agencies have sought to discourage the provision of bribes by foreign nationals. The UN Convention against Corruption attempts to discourage corruption by making the payment of bribes abroad a criminal offense prosecutable in the home countries of foreign nationals. The OECD Anti-Bribery Convention takes a similar approach.

The empirical connection

We have examined the consequences of corruption and the impact on PFM performance from a statistical perspective in several ways. We summarise our conclusions in this section (all correlations are significant at a 99% confidence level except where otherwise stated). We also illustrate here the chain of events implicit in the data.

Firstly, we have correlated control of corruption (capturing perceptions of the extent to which public power is exercised for private gain) and government effectiveness (including the quality of public services) for 184 countries using data from the World Bank's 2013 Worldwide Governance Indicators, together with World Bank 2013 per capita income data and Rand Corporation's Trace (bribery) Matrix risk scores for these countries (see Table 1).

Table 1: Corruption Correlations

Corruption measure	WGI Government Effectiveness	GDP/head
WGI Control of Corruption	Significant correlation	Significant correlation

Trace (bribery) Matrix[5]	Significant inverse correlation	Significant inverse correlation

Indicators of corruption are highly subjective and therefore of questionable validity. Nevertheless we note the similarity of the significant relationships achieved from the two different indicators of corruption and hence believe in the validity of the relationships.

We also correlated some recent measures of PFM performance with measures of corruption and government effectiveness for 39 developing countries for which Public Expenditure and Financial Accountability (PEFA) assessments[6] were made available during the past three years from 2013 to 2015 (see Table 2).

This second set of correlations is more problematic. PEFA indicators are not designed to isolate activities that are most indicative of corruption and recent PEFA results together with government effectiveness, control of corruption and Trace risk scores were only available for thirty-nine countries. Despite this hindrance and the inherent weakness in the corruption data mentioned above we find some significant statistical relationships amongst the indicators that cover activities most vulnerable to corruption or concerned with its detection. This seems to suggest that PFM, or at least some aspects of PFM, is relevant to combatting corruption and securing government effectiveness.

Table 2: PFM Correlations to Corruption and Government Effectiveness			
PFM quality assessed using PEFA Performance Indicators	**Control of Corruption**	**Trace Risk Index**	**Government Effectiveness**

Degree of integration & reconciliation between personal records and payroll data	Significant Correlation	No significant correlation	Significant Correlation
Effectiveness of internal controls for non-salaried expenditure	No significant correlation	Significant Correlation	Significant Correlation
Frequency and distribution of internal audit reports	Significant correlation*	Significant Correlation	Significant Correlation

**This correlation is significant at a 95% confidence interval.*

The general inference we take from this exercise is that good PFM practice is likely to be beneficial to the advancement of good public service delivery and economic performance in developing countries.

Effective PFM reforms to combat corruption

Endemic corruption should be confronted through location-specific action prioritized on three factors: national detriment, effectiveness of the measures proposed, and capacity of the administration to effect the proposals.

Reform proposals should be designed to cover key weaknesses but avoid technical complexity that cannot be sustained. For instance, does the state have a sufficiently robust communications network and the necessary information and communications technology skills available to enable public sector organisations to undertake their purchasing from private sector suppliers using internet-based systems; or, are manual system improvements coupled with greater transparency in awarding contracts preferable, at least in the short term? Next, financial regulations need to be coherent and simplified where necessary. They should be more exacting in areas of high risk and high value.

Internal audit often requires improved capacity and must have reporting access to the most senior government official. External audit reports should have full public disclosure and external auditors should have access to public accounts committees that are informed by independent expert support.

The public must be made aware of the service standards they can expect and have access to effective complaints mechanisms in order to ensure value for money. Also, business and professional associations must be encouraged to voice concerns about corruption and poor financial practices.

Transparency of policy decisions and of financial performance is imperative through government information systems, among which government websites are increasingly important. But free media reporting and comment are essential to securing all such reforms.

Wider supportive activities

Perhaps some of the most important PFM reform activities are not of a strictly financial nature. Senior officials and politicians must demonstrate exemplary leadership, civil service watchdogs should underpin standards of conduct and should be invested with investigatory powers, codes of conduct should be adopted as a condition of employment, recruitment must be made on merit, appraisal and disciplinary processes must be robust, and there must be adequate standards of induction and in-service training.

Judicial systems must be freed from corruption and political interference, and consideration should be given to establishing special courts for corruption.

Opportunities for corruption can be reduced by avoiding personal contact through the use of online service delivery (where feasible) and by eliminating unnecessary bureaucracy.

Transferring services of a commercial nature from public to private sector providers should be considered, although this requires careful implementation and continuing regulation in some cases.

The role of development partners

International development partners, particularly the large aid organizations, are well positioned to establish appropriate incentive frameworks, identify opportunities, and adopt the necessary long-term perspective required for PFM reforms. These situations are not suitable for pre-packaged solutions. Rather, the frameworks should include actively managed, locally focused programs requiring collaboration between governments and development partners to track progress and drive change, with ownership of the programs vested in client states.

Development partner funding for reform activities should be linked to the attainment of specific milestones previously agreed with governments and released in tranches as agreed reforms are realized. Such improvements are beginning to gain ground and must be complemented by effective advocacy for transparency in financial matters and press freedom.

Conclusion

The level of corruption in developing countries, including the use of tax havens for sheltering the proceeds of top tier corruption, has become a current issue. In addition, corrupt environments threaten trade relations with developing countries and the criminalization of bribery in the home countries of foreign nationals, although an essential development, adds to the deterrent effect for foreign-based businesses.

Economist Gabriel Zucman estimates that over 30 percent of all Africa’s financial wealth is stored in tax havens, of which it may be assumed that a substantial proportion goes untaxed. The conclusion drawn from this is that even if the poor pay their fair share in taxes, the world's wealthiest often do not. Reforms of tax law and administration are clearly required as part of the PFM reform agenda.

The eradication of endemic corruption is an enormous challenge for developing countries. PFM reform has much to offer, but international development partners need to do more to support collaborative change processes and plan for the long haul.

[1] David Fellows and John Leonardo are Principals and Cornelia Körtl is an Associate of PFMConnect. Their work covers development projects in Africa, Asia, and the Pacific Islands.

[2] A wide-ranging discussion **of** PFM practice is well beyond the confines of this article. We refer only to practices that are particularly relevant to the control of corruption. *See* Stephen Peterson 'Public Finance and Economic Growth in Developing Countries: Lessons from Ethiopia's reforms' for a thought-provoking and very readable commentary on the challenges facing those who would design financial systems for developing countries.

[3] World Bank: Combating Corruption in Indonesia *Enhancing Accountability for Development* 2003

[4] Mushtaq Khan understands corruption as a 'type of illegal rent seeking' (*Khan, 2006. State weakness in developing countries and strategies of institutional reform – Operational Implications for Anti-Corruption Policy and A case-study of Tanzania, p.9*). For a complete understanding of his theory on rent-seeking see Khan, M. and Jomo, K.S. (eds) (2000). *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia. Cambridge*: Cambridge University Press.

[5] The Trace Matrix assesses the risk of encountering business bribery in a particular country; higher scores imply higher risk of encountering bribery expectations (for more

information see here). A discussion of the methodology employed to determine the correlations presented in Tables 1 (and 2) is available here.

[6] For the PEFA system and its findings see www.pefa.org

Trend in Papua New Guinea’s public financial management

SlideShare presentation

We have prepared a SlideShare presentation that discusses the desperate state of Papua New Guinea's public financial management (PFM). The presentation highlights a deteriorating trend in the country's PFM over recent years and its very poor recent performance compared with most other countries based on Public Expenditure and Financial Accountability (PEFA) assessment methodology. The presentation recommends the government publishes its recently prepared PFM reform road map to facilitate an open evaluation of the root causes of Papua New Guinea's poor PFM performance and reform options by a full range of stakeholders. We end the presentation by reiterating our view that in its current form PEFA methodology is unsuited to play a really constructive role in the reform of PFM practice in fragile states.

Papua New Guinea's poor and deteriorating financial management: can it be turned around?

By David Fellows and John Leonardo[1]

Background on Papua New Guinea (PNG)

Papua New Guinea (PNG) is a lower-middle-income economy heavily dependent upon commodity exports. It has an extremely diverse social structure with fierce clan loyalties, characteristics that provide severe challenges to the effective working of government that have not yet been successfully addressed.[2] [3]The country's social development[4] trails its economic status. Overall, the performance of the PNG public sector is weak, the lower tiers of government are dysfunctional and corruption is rife.

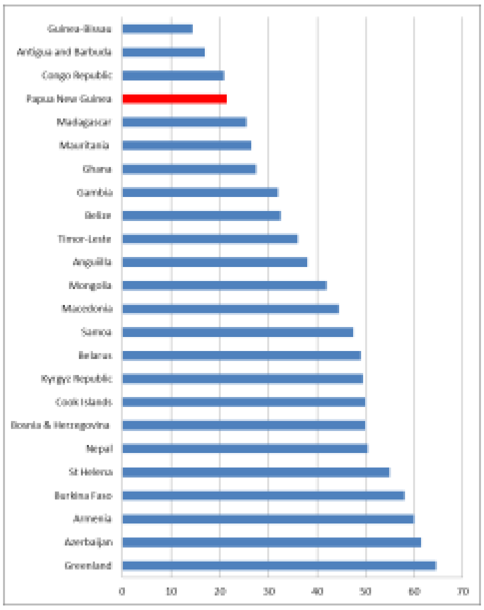
Key findings of PNG’s latest PEFA assessment

The latest PNG Public Expenditure and Financial Accountability (PEFA) assessment completed in August last year has been published. Scores for the various public financial management (PFM) performance indicators (PIs) were determined using both a new so-called “testing” methodology and the existing 2011 methodology. Details of the scores are available in this spreadsheet and a summary of the new testing methodology scores are given at the end.

The PEFA exercise gives ranking for about 30 criteria on a scale from A to D. In the 2015 assessment, A and B scores represented a very disappointing 17% of all PI scores applying the new testing methodology or 18% using the 2011 methodology. Nine out of the ten scores under the two key headings of ‘Predictability & Control in Budget Execution’ and ‘Accounting, Recording and Reporting’ were ‘D’ or ‘D+’. In many cases financial regulations and improvements recommended by internal audit review were simply not observed reflecting perhaps a mixture of poor oversight, inadequate training, lack of basic ability and blatant disregard for proper practice.

Twenty-four PEFA assessments have been completed since 1 January 2014 and published by the PEFA Secretariat. (In addition, six completed assessments have not been published to date.) As the graph in Figure 1 below shows, Papua New Guinea’s overall score was ranked 21st out of the twenty-four countries. (Details are available here, including our methodology to derive aggregate scores from PEFA rankings.) Only Congo Republic, Antigua and Barbuda and Guinea-Bissau recorded lower overall scores than Papua New Guinea.

Figure 1: Aggregate PEFA scores for 24 countries



Note: The PEFA scores are aggregated by us using a methodology set out in the spreadsheet mentioned above. The highest possible score is 84.

PNG is also one of the poorest countries rated, but its overall performance is weaker than some other even poorer developing countries as set out in Table 1 below.

Table 1: PEFA scores sorted by Gross National Income (GNI) per capita (US$)

	GNI per capita 2014	HDI* 2014	PEFA score
Papua New Guinea	2,463	0.505	21.5
Nepal	2,311	0.548	50.5
Burkina Faso	1,591	0.402	58
Gambia	1,507	0.441	32
Madagascar	1,328	0.510	25.5

*Human Development Index

What is also disturbing is the suggestion that financial management in PNG has worsened. Two earlier PEFA exercises have been carried out for PNG, in 2005 and 2009. While these have not been released, we know from the ADB's Country Operations Business Plan 2015-2017 that in 2009 32% of PIs were scored an A or a B. The fall from 32% to 18% suggests a major deterioration in public financial management in PNG. (The 2005 methodology used in 2009 and the 2011 methodology used in 2015 are not identical, but sufficiently similar for this comparison to be made.)

The IMF team observes that PNG's budget process is orderly and well understood, and that some progress has been made in embedding the medium-term dimension into fiscal planning. The aggregate credibility of the budget appears satisfactory though only with some serious caveats. Most of the 2015 report, however, contains a damning indictment of financial administration: control over budget execution is weak; there are high levels of variance between budget and expenditure; expenditure control is weak; project implementation is weak; budgets contain insufficient analytical detail; many bank reconciliations are not carried out in a timely manner and contain significant unresolved items; the coverage and classification of in-year data does not allow comparison with original approved budgets; many state owned enterprises receive very poor audit reports; there is no overall PFM reform strategy; and much else besides.

In our recent blog "Proposals for PEFA reform", we remarked on the failure of the PEFA methodology to come to terms with fundamental institutional weaknesses. The PNG assessment contains a short section on institutional factors but fails to establish the root causes of the perceived deficiencies. The remedies proposed – including the use of a longer time span, creating a more structured approach and the formation of a Ministerial steering committee – are worthy but unequal to the task of addressing the long list of recommended priority improvements that end the report.

Readers of the report are left asking for an explanation of underlying reasons for this catalogue of critical deficiencies, the lack of progress made and the decline in standards in some areas.

PNG’s response

The PNG government has made no formal response to the latest PEFA assessment but the recent Budget Speech contains reforms concerning state-owned enterprises, Government Finance Statistics and debt management that partially address material weaknesses identified in the latest PEFA assessment. There were no specific initiatives to promote increased accountability in PFM activities in either the 2016 Budget Speech or supporting volumes.

The government’s stated expectation in the 2016 Budget that the 2015 PEFA assessment “should provide confidence to development partners to gradually rely on government systems” (Vol. 1, p. 46) appears optimistic to say the least.

Following the completion of the PEFA assessment the IMF and the Government of PNG created a “road map” for public financial management (PFM) reform. This is referred to in the IMF 2015 Article IV report, but has not been published, as far as we can tell. It seems to have been designed to give effect to the extensive list of priority reforms identified in the 2015 PEFA assessment but the published fragments are lacking in explanation about how these improvements are to be achieved. It was not, as far as we are aware, created out of any form of extensive public or corporate consultation.

Conclusions

PFM reform is not an end in itself nor can it be achieved in isolation from the broader condition of a fragile state. Good

PFM is, however, an essential component of policy development, service and project implementation, obtaining value-for-money, promoting economic development, fighting corruption and providing public accountability.

Clearly, financial management in PNG is in a parlous state. No significant progress has been made in most PFM activities at government level in recent years; indeed there is evidence of regress.

The failure to publish previous PEFA reports has denied both the tax payers and the people of PNG with any real appreciation that the resources expended on PFM enhancement activities have generally failed to produce material overall improvements in key PFM areas. A stance must now be taken by international development agencies that all future work in relation to the reform of PFM in PNG must be undertaken in a much more transparent manner. A good start would be to publish the road map.

There is an opportunity for progress with a Finance Minister, James Marape, committed to reform and a Finance Secretary, Dr Ken Ngangan, who is well-respected and capable. However, the effort, to be successful, must go beyond a small number of individuals. We suggest that, given the relative failure of reform activity to-date, there should be an open assessment of the public financial management reform challenges and their root causes involving the full range of stakeholders. This should result in an agreed set of objectives, reform processes, expected performance levels and timescales designed to deliver feasible and desirable improvements in administrative practice, governance and political relationships to achieve an acceptable minimum overall PFM standard. External agencies should require evidence of extensive support from the government of PNG as a condition of continued participation in the reforms. A collective approach to the problems of PNG involving Government and development partners could provide added value from the future resources deployed by all parties.

Unlikely though the achievement of these proposals may seem, donors must now ask themselves what purposes further reform activities are expected to serve if they choose to ignore their lack of results. The ADB country plan for PNG expected the proportion of As and Bs to rise from 32% in 2009 to 50%[5] in 2015. Instead, it has fallen to 18%.

As we have said before, the PEFA methodology can no longer ignore the need to identify the root causes of poor PFM in fragile states. PNG seems to offer a perfect case in point.

APPENDIX

PNG 2015 PEFA Scores (using "testing" methodology)

PFM Pillars	Performance Indicator (PIs) Scores*			
	A	B	C	D
Credibility of Fiscal Strategy *(PI:1-3)*	1	1		1
Comprehensiveness and Transparency *(PI:4-9)*		2	1	3
Asset & Liability Management *(PI:10-13)*				4
Policy-based Planning & Budgeting *(PI:14-18)*		1	2	2
Predictability and Control in Budget Execution *(PI:19-25)*			1	6

Accounting, Recording and Reporting *(PI:26-28)*				3
External Scrutiny and Audit *(PI:29-30)*				2
Total scores	**1**	**4**	**4**	**21**

**each column includes '+' scores, so 'D'; includes D and D+*

[1] The authors are Principals of PFMConnect. They have been engaged on projects in Africa, Asia and the Pacific funded by major development partners. A slightly abbreviated version of this blog is available at the Devpolicy Blog of the Development Policy Centre based at the Australian National University's Crawford School of Public Policy.

[2] The three Political Economies of electoral quality in PNG & Solomon Islands by T. Wood ANU DevPolicy Centre

[3] Political Governance & Service Delivery in the Western Highland Province, PNG by J. Ketan ANU ISSN: 1328-7854

[4] Asian Development Bank Country Partnership Strategy Papua New Guinea 2016–2020, March 2015, page 1

[5] This was an objective included in ADB's Country Operations Business Plan 2015-2017 "Updated Country Partnership Strategy Results Framework" published in October 2014. This document was superseded by ADB's Country Operations Business Plan 2016-2018, published in March 2015, from which this objective was omitted