

# Lessons from Public Financial Management (PFM) reforms after a financial crisis

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## Question

*What types of Public Financial Management (PFM) reforms in developing countries were introduced following a financial crisis, and what are the lessons learned from the reforms?*

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## Summary

This rapid review synthesises the literature from academic, policy, and knowledge institution sources on what types of Public Finance Management (PFM) reforms in developing countries were introduced following a financial crisis. **PFM frameworks and reforms often originated in circumstances of crisis.** As Annex 1 shows, lessons from previous crises could give useful insight in how government financial management systems could be adapted in the context of the current Covid-19 crisis. **This review does not suggest that fiscal responses and PFM reforms as mentioned in this report are all adequate measures for the Covid-19 crisis as the impact of PFM systems, strategies and reforms are very context specific.** Annex 1 gives some useful links to sources that relate to PFM responses during the Covid-19 crisis.

**The literature used in this review looks mostly back to the Asian Financial Crisis (1997-1998), Global Financial Crisis (2007-2008), and the commodity price crisis in 2014-2015 affecting mainly resource-rich developing countries.** As a result, the literature is often from around those periods and, therefore, not from the last five years as would be normally the case for K4D Helpdesk reports.

**The overall conclusion from this report is that PFM reforms indeed have played a significant role in setting up effective, efficient, and transparent fiscal stimulus packages (e.g. cash transfers, public work programmes) measures during and after a crisis.** The review also shows that it is important to separate short-term PFM reforms or responses that allow adaptations of the fiscal framework to let fiscal responses (e.g. stimulus packages) happen during a crisis, and longer-term PFM reforms after a crisis that prevent and better equip governments for a potential financial crisis. The focus areas of PFM reforms are mainly risk management (e.g. through control of the fiscal balance and aggregate spending), allocative efficiency (e.g. through prioritisation of expenditure), effectiveness and efficiency of expenditure (e.g. through value-for-money measures), and financial management transparency (e.g. through web-based systems and awareness programmes).

This review uses the same structure to explain the types of PFM reforms and lessons learned from them as mentioned in Wendling et al. (2020), separating reforms in the design, implementation, and oversight phases of the PFM cycle. By doing this, this rapid literature review makes the following points:

### **PFM reforms and lessons in the design phase:**

- Parliamentary scrutiny and securing legal authorisation of policy measures are necessary, according to each country's institutional framework – in most cases through a Supplementary Budget.
- In countries where existing social protection programmes are weak, the crisis may provide an opportunity to strengthen them, through both expanding coverage and increasing benefits. The design of the programmes can be gradually refined over time.
- A large shock may also expose weaknesses in the design of the fiscal rules, which generate fiscal stability and increase the ability to adequately respond to crisis. However, fiscal rules must be sufficiently flexible to manage unexpected economic or other large shocks.
- Escape clauses in fiscal rules are only useful as they are accompanied by clear guidelines (how and when to use them), including an effective control mechanism.

- Spending needs are best prioritised in a transparent, but quick way by preparing estimates of additional resource requirements.
- Even under strong time pressure, there should be consulting with stakeholders, both to improve the design of the support package and to help build support amongst economic actors.

#### **PFM reforms and lessons in the implementation phase:**

- Crisis-related budget and spending measures should be presented with specific crisis-related measures in the budget with clear performance indicators to facilitate the ex-post assessment of impact.
- Additional crisis-related spending should be tracked, ideally through dedicated programmes or sections of the budget. Good recording will make it easier to cease temporary spending arrangements once the need is over.
- Often a stream for handling priority items and fast track expenditure authorisations for the most prioritised measures is created.
- Adopting a risk-based approach to controls is often recommended. For example, pre-audit can focus only on high-risk payments, while relatively less risky payments may be subjected to post-audit.
- The biggest challenge will likely be the beneficiary authentication, fraud prevention, and corruption within the PFM system, in particular, as quick responses are needed.
- Coordination with subnational governments/entities are important in understanding the needs at the grassroot level.
- Risk management mechanisms should be in place to control and monitor risk exposure.

#### **PFM reforms and lessons in the oversight phase:**

- Monitoring and accountability system should be independent and transparent focusing on both complying to fiscal rules, advising on any changes in such rules, and evaluating impact and quality of public investments.
- However, most governments in developing countries have not established an external oversight body tasked with monitoring compliance with their fiscal rules. In the cases where there is limited technical capacity but already one established institution working on public finance, it may be beneficial to build on it and expand its remit, rather than setting up a new institution.
- Many fiscal councils must, as part of their mandates, check compliance with fiscal rules, although they cannot prevent governments from actually breaking these rules.
- Countries with national independent oversight bodies are more likely to follow fiscal rules than countries with no formal oversight. But fiscal councils require capacity and strong governance structures, which may be difficult to establish, especially in low-income countries.

#### **Some more general lessons mentioned in the literature, are:**

- It is difficult for fiscal stimulus to be effectively implemented in timely, targeted, and temporary manner often because of the political process that precedes the delivery of the stimulus. Such fact points to the need for enhancing the scope and effectiveness of

automatic stabilisers, the fiscal policy tools that respond immediately and symmetrically to business cycle fluctuations (ILO et al. 2011).

- Even in the most favourable of circumstances, the scale and complexity of the tasks to be undertaken are enormous, requiring levels of coordination and collaboration that may be without precedent for those involved. As such the pace and coherence of PFM reforms is important. Reforms are to be undertaken incrementally, allowing for adaptation and experimentation, in particular when PFM reforms are combined with decentralisation processes (Woolcock et al., 2018).
- Because many low-income countries have no robust PFM system in place, they could follow a policy guideline (instead of fully implementing a fiscal policy framework) to enhance fiscal discipline without formally committing to a specific fiscal framework until it has gone through a learning process and has established a better PFM system (Sharma & Strauss, 2013).
- Needs to achieve goals of reforms are mainly concentrated on technical assistance, legal frameworks, and capacity building of employees. As such most emphasis in reforms is on building internal transparency, control, and capacity systems. However, there is less focus on strong public pressure for change (Grant Thornton, 2013).

Finally, this report includes several Annexes that explain in more details 1) what specific fiscal responses governments in developing countries have used in the aftermath of a crisis (Annex 2), 2) how in particular resource-rich developing countries deal in PFM systems to tackle procyclical budgeting (Annex 3), and 3) a specific case study on Indonesia as a country that initially struggled but in the end successfully established PFM reforms after the Asian Financial Crisis and partly due to these reforms could respond well to the Global Financial Crisis.

## 1. Framing PFM interventions after financial crises

**Public Finance Management (PFM) is the processes through which public funds are managed.** Piatti-Fünfkirchen and Schneider (2018) mention the three overarching objectives of PFM as: aggregate fiscal discipline, operational (or technical) efficiency, and allocative efficiency. Although PFM systems and strategies are adapted over time, a financial crisis and its aftermath change radically the landscape of government budgeting. **Fiscal circumstances (revenues and expenditures) deteriorate significantly after a financial crisis, forcing a rethinking of the main directions of PFM systems, strategies and reforms** (OECD, 2015). Countries that face a financial crisis need costly emergency stimulus packages to rescue the economy and welfare of citizens (see Annex 2). Hence, governments have to take into account the long-term element of **expenditure pressure** as they can expect potentially large future increases in interest expenditure due to interest-rate increases on rapidly increasing levels of government debt.

The other problem governments face after a financial crisis is **slow revenue growth**. In emerging economies, low-income countries (LICs), and lower-middle-income countries (LMICs), the tax base is already low due to trade liberalisation and tax competition. The result is that governments in LICs and LMICs are more dependent for revenues on corporate taxes from a

small number of large firms.<sup>1</sup> Particularly resource-rich countries show high volatility on their corporate tax revenues, making them extra vulnerable for low commodity prices which occur during and in the aftermath of financial crises (see more in Annex 3). **Slow revenue growth makes it not only harder to control deficits in the short run, but also makes it much more difficult to reduce the effective debt burden in the long-term.**

Financial crises impact on countries differently due to the specifics of the financial crisis itself, but also due to countries' specific financial and economic (e.g. debt, exchange rate, export base) positions antes-crisis. **Governance specifics and political economy are also important because quick, adequate, effective, transparent and decisive government responses and control mechanisms are needed to tackle financial crises and their economic downturn** (Hill, 2012; Fritz et al., 2017). This is where PFM has a role to play, in shaping a country's fiscal framework and decision-making processes within the budgetary cycle. This cycle, also called PFM cycle, contains different phases:<sup>2</sup>

- It starts with the **budget planning** phase, which is a strategic phase with internal control mechanisms within government to come to a budget decision.
- The next phase is **budget preparation and legislation**, in which Parliaments have an important internal control function.
- This is followed by the **budget execution** that involves managerial activities within the public services, with internal control and audit mechanisms in government institutions.
- The fourth phase involves **accounting and reporting** about implementation and progress.
- This is followed by the **external control and audit** phase.
- The cycle ends with a **legislative oversight** that should lead to a new cycle of planning a new budget within the fiscal framework.

This report identifies what PFM reforms (short-term and long-term) emerging economies and developing countries in Asia and Sub-Saharan Africa (to some extent in Latin America) have installed after they faced a financial crisis or severe economic downturns. **It is important to separate short-term PFM reforms or responses that allow adaptations of the fiscal framework to let fiscal responses (e.g. stimulus packages) happen during a crisis, and longer-term PFM reforms after a crisis that prevent and better equip governments for a potential new financial crisis.**<sup>3</sup>

Spilimbaro et al. (2008) make the point that **the optimal fiscal package should be timely, large, lasting, diversified, contingent, collective, and sustainable to have any effect after a major financial crisis.** The explanation is that the need for action is immediate, the expected decrease in private demand exceptionally large, that the downturn last for some time with a unusual degree of uncertainty associated with any single measure, which requires a collective

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<sup>1</sup> See for example: Quak, E. (2018) The Impact of International Tax Competition on Low and Middle-Income Countries. K4D Helpdesk Report. Brighton, UK: Institute of Development Studies. <https://www.gov.uk/dfid-research-outputs/the-impact-of-international-tax-competition-on-low-and-middle-income-countries>

<sup>2</sup> See for example <https://gsdrc.org/professional-dev/public-financial-management/> and [https://www.cabri-sbo.org/uploads/files/Documents/Cabri\\_Module-1-ENG.pdf](https://www.cabri-sbo.org/uploads/files/Documents/Cabri_Module-1-ENG.pdf)

<sup>3</sup> Author's own observation from the literature.

commitment, although it should not lead to a debt explosion and adverse reactions of financial markets (Spilimbaro et al., 2008). In this complex web with often opposed stakes at play PFM reforms take shape.

**For any fiscal stimulus, short-term PFM interventions are needed to improve the decision-making processes, flexibility in implementation measures, and efficiency of monitoring during a crisis.** On the other hand, PFM reforms after a financial crisis can also be longer-term interventions, whose focus and goal is often less clear to peg them back to the financial crisis and therefore relate to much more issues than emergency fiscal responses. Although this distinction is clear for the timeframe and goals, **both focus on the same PFM issues.** PFM reforms that occur after a financial crisis relate to (e.g. OECD, 2015; Grant Thornton, 2013):

- Risk management (e.g. through control of the fiscal balance and aggregate spending).
- Allocative efficiency (e.g. through prioritisation of expenditure).
- Effectiveness and efficiency of expenditure (e.g. through value-for-money measures).
- Financial management transparency (e.g. through web-based systems and awareness programmes).

Grant Thornton (2013) did a worldwide survey amongst government representatives in developing countries (although not exclusively) regarding PFM reforms after the Global Financial Crisis (GFC) in 2008. **The GFC provided many countries with an impetus to improve PFM practices.** Even in the very small number of countries where respondents reported that the crisis had a minimal impact and did not require policy changes, the GFC provided support for the government to improve service delivery effectiveness and efficiency.

The report indeed shows that many countries established PFM reforms around the above-mentioned areas. For example, countries established **processes to recognise fiscal risks** as a result of the GFC. However, fewer countries stated PFM reforms to improve **methods for better understanding future costs of current policies** (e.g. impact assessments or scenario analyses for preparing budgets and forecasting costs in medium- and long-term strategic plan development). An area that has improved particularly after the GFC regarding risk management are **independent internal control and audit measures.**

Through **expenditure prioritisation**, important benefit programmes and obligations to health care services, for example, could be spared or less damaged by stricter fiscal balance rules. Furthermore, allocation of budgets to government agencies have been targeted much more to their specific needs, which are **measured according to the accomplishments** of their major final outputs. The Grant Thornton (2013) report also refers to PFM reforms to improve the effectiveness and efficiency of expenditures through **Public Expenditure Tracking (PET)** surveys, **performance-based incentives**, and clear **indicators to measure outcomes.**

## 2. PFM reforms after financial crises

Annex 2 shows that **as a percentage of 2008 GDP countries in Asia and the Pacific spent the most on fiscal stimulus packages as a response to the GFC. Africa and the Middle East are second.** Asia and the Pacific (not including Japan and Korea) spent 9.1% of its 2008 GDP on stimulus efforts (weighted average by country size) (ILO et al., 2011). More importantly, the studies by Khatiwada (2009) and ILO et al. (2011) particularly show a clear distinction between developed and developing countries. **Advanced economies focussed mostly on tax**

**cuts while developing and emerging economies focussed on infrastructure spending.** It is important to note that PFM systems, strategies and reforms are at the heart of the decisions that have shaped such fiscal responses.

Short-term and longer-term PFM reforms often occur in the aftermath of a financial crisis or severe economic downturn, because a crisis generates conditions to test PFM systems and frameworks thoroughly in decision-making (design), implementation, and oversight.

**Emergencies also generate insight into how transparent the PFM system is – since crises offer a “fertile ground for vested interests to use public funds for private gain, making it critical that vulnerabilities to corruption and misuse be recognised and mitigated”**

(Wendling, 2020, p.3).

Wendling et al. (2020) provide the 2015 example of the **Sierra Leone** Auditor General audit of domestic donations that the government made for the Ebola relief effort. The audit provides evidence of mismanagement by public officials in the distribution of these funds. Payments for supplies and sensitisation efforts were duplicated and undocumented, money was paid out to private individuals rather than to organisations and procurement procedures were widely disregarded. Audits of international development organisation spending showed there was also a **failure to provide rightful healthcare workers’ salaries** and bonuses which were paid out to private individuals by those charged with distribution (Wendling et al., 2020).

By following the PFM cycle, this review will highlight different PFM reforms in the design, implementation and oversight phases after a financial crisis. In emerging economies and developing countries, these measures are often taken in cooperation with the IMF and other international donors in combination with technical assistance and capacity building. However, **‘best practice’ in one country is not per se the answer for another country, even in the same region.** Country-specific PFM needs, institutional capacity (consultation, decision-making, implementation, monitoring), and extent of exposure to external shocks are important factors that create different environments that put fiscal frameworks (e.g. different set of fiscal rules and funds) in place that ultimately impact on country-specific PFM interventions after a crisis.

Because of the very specific needs per country this part has a more generally approach on PFM reforms after a financial crisis or severe economic downturn, mainly based on some recently published IMF sources on experiences of PFM responses after an emergency or crisis.

## **PFM reforms and lessons in the design phase**

The key challenge is to balance the urgency and timeliness of the response in a volatile economic environment with achieving transparency in the identification and presentation of the response measures (Wendling et al., 2020). **Parliamentary scrutiny and securing legal authorisation of policy measures are necessary, according to each country’s institutional framework – in most cases through a Supplementary Budget.** However, as Box 1 shows earmarking specific spending in budgets for a longer period is not always efficient.

**Countries should prioritise measures that are consistent with their medium-term development needs** (Shang et al., 2020). In countries where existing social protection programmes are weak, the crisis may provide an opportunity to strengthen them, through both expanding coverage and increasing benefits. Furthermore, **the design of these programmes can be gradually refined over time.** For example, “where a universal cash transfer programme is introduced, its coverage of the hard-to-reach segments of the population may be further

improved, and targeting may be introduced directly for these programmes or through the tax system” (Shang et al., 2020, p.2).

**A large shock may also expose weaknesses in the design of the fiscal rules, which generate fiscal stability and increase the ability to adequately respond to crisis** (Mihalyi & Fernández, 2018). The IMF (Schächter et al, 2012) classifies fiscal rules in four categories, however, in practice, governments often use some combination of these rules (i.e. debt rules, budget balance rules, expenditure rules, and revenue rules).<sup>4</sup> It is important to note that the literature on fiscal rules is clear; **fiscal rules must be sufficiently flexible to manage unexpected economic or other large shocks** (Eyraud et al., 2018; Mihalyi & Fernández, 2018), even require escape clauses to allow temporary deviations from the rules (Gbohoui & Medas, 2020). The use of escape clauses “should involve a well specified and transparent process to preserve the credibility of the framework”, write Gbohoui and Medas (2020, p.1). In addition, faced with a crisis some countries either do not have escape clauses and may need to consider suspending their rules without a well-defined process or even abandoning or revising the rules.

The collapse in commodity prices in 2014 and 2015 prompted many commodity exporters to revise or recalibrate their fiscal rules. **The GFC also has put many fiscal rules to tests, prompting a raft of reforms to rules including the introduction of new rules, revamping of escape clauses, and enhancement of monitoring and enforcement mechanisms.** As a result, several countries have introduced escape clauses in their fiscal rule frameworks after the GFC. Gbohoui and Medas (2020) show that **cross-country experiences** suggest that a well-defined escape clause should specify:

- a limited and clearly defined set of events triggering the operation of the clause,
- the authority to activate it,
- the timeline and procedures to revert to the rule,
- an effective control mechanism, and
- a good communication strategy.

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<sup>4</sup> **Debt rules** set an explicit limit or target for public debt in percent of GDP. However, debts are mostly affected by changes in interest or exchange rate and less by budgetary measures. These rules limit countries from borrowing in downtime periods but do not often prevent resource-rich countries' governments from high debts in boom periods (Mihalyi & Fernández, 2018, p.10). **Budget balance rules** constrain the variable that primarily influences the debt ratio and are largely under the control of policy makers. However, budget balance rules are procyclical because they allow expenditures to increase with rising revenue, and if binding, they force expenditure cuts when revenues are declining. As such, these rules transmit the volatility of resource revenue into fiscal policy in resource-rich countries and do not provide flexibility in adjusting to larger commodity price drops (Mihalyi & Fernández, 2018, p.9). Some countries have non-resource current balance rules to avoid procyclical budgeting, however, these countries might create parallel budgets for current and capital spending (Sharma & Strauss, 2013). **Expenditure rules** set limits on total, primary, or current spending. However, governments can circumvent rules by engaging in off budget spending and not providing flexibility to respond counter-cyclically to commodity price shocks. Furthermore, governments may try to comply with an expenditure rule by cutting productive spending too much compared with non-productive spending. Countries with new resource discoveries but limited spending capacity may consider using expenditure rules to surmount pressures to spend based on expectations of future wealth (Mihalyi & Fernández, 2018, p.11). **Revenue rules** set ceilings or floors on revenues and are aimed at boosting revenue collection and/or preventing an excessive tax burden. Many resource-rich countries have set up regulations to limit how much resource revenue should enter the budget and how much they should deposit into a sovereign wealth fund (see section 3). However, these rules only constrain government finances if complemented by other rules that limit borrowing or debt. Otherwise, governments can save a portion of revenues, while borrowing at the same time and fail to achieve their objectives (Mihalyi & Fernández, 2018, p.11). See for a far more detailed list of fiscal rules Ossowski & Halland (2016) p.60-62.



As further explained in Annex 3, **the Peru case is interesting because the country invoked a well-defined escape clause since 2013 rather than modify or break its fiscal rule.** Although many countries have an escape clause for their fiscal rules, only Peru has specific operational guidance on how to activate the escape clause in event of a natural disaster or international crisis (Mihalyi & Fernández, 2018). **Peru also has a build-in monitoring and internal and external control system.** For example, in Peru, the fiscal council supported the decision to suspend the rule in 2020-21, due to the Covid-19 crisis, but recommended the publication of reports assessing the exceptional measures being adopted and explain the target for the deficit in 2021 to ensure transparency and accountability (Gbohoui & Medas, 2020).

However, the Peru case is an exception as **most escape clauses in fiscal rules are less well designed and controlled, making them vulnerable for political interests.** Furthermore, frequent revisions may signal weak government commitment to fiscal discipline and have adverse market reactions (higher borrowing costs). In general, **rules should not be revised unless there are large and persistent deviations from “first-best” policies** (Eyraud et al. 2018).

On another note, **crisis-related budget and spending measures should be presented with specific crisis-related measures in the budget with clear eligibility criteria and ensuring granularity of information and performance indicators to facilitate the ex-post assessment of impact** (Wendling et al., 2020). Spending needs to be prioritised in a transparent, but quick way. Countries often prepare quick estimates of additional resource requirements, take extra care that high priority expenditures including the support to vulnerable people and sectors are not adversely impacted, and line ministries are asked by the Ministry of Finance to provide savings in their respective budgets on a consideration of these policy priorities and progress (Wendling et al., 2020). Furthermore, **medium-term budget frameworks could be adapted due to the impact of reprioritisations and higher debts.**

**Even under strong time pressure, there should be consulting with stakeholders, both to improve the design of the support package and to help build support amongst economic actors.** Expert and independent civil society organisations (CSOs) can provide inputs to improve the design of fiscal measures or help target it to specific, at-risk constituencies. For example, in the case of the current Covid-19 crisis, Côte d’Ivoire, before announcing its pandemic policy response at the end of March 2020, it had held consultations at the level of the Minister of Finance with banks and employers’ unions (Wendling et al., 2020). Also, in Mexico, CIEP (Centro de Investigacion Economica y Presupuestaria, Center for Economic and Fiscal Studies) produced proposals on various policy alternatives to reallocate budget resources and provide economic support in the present crisis (Wendling et al. 2020).

## **PFM reforms and lessons in implementation phase**

The key challenge in this phase of the PFM cycle is to **have adequate control and tracking/traceability of budget and off-budget interventions,** to ensure that the agreed emergency measures are deployed effectively and in line with their intended purpose and – if needed – allow revising and adapting the set of measures to changing circumstances (Wendling et al. 2020).

Saxena and Stone (2020) show that **additional crisis-related spending should be tracked, ideally through dedicated programmes or sections of the budget.** They also show that it is important to be transparent in applying off-budget measures such as guarantees, which

constitute a significant part of support packages in crisis. **Good recording will make it easier to cease temporary spending arrangements once the need is over.** Feedback loops are important for timely information delivery to policymakers. As the Grant Thornton survey (2013) shows, respondents indicated that the most common method to measure the effectiveness and efficiency of service delivery in PFM practices after the GFC appears to be through incorporating performance management into the budget process, however, **challenges still occur, particularly in implementing a performance measurement system.**

When rapid implementation of the policy response requires adapting existing rules to provide more flexibility, this has to be done in a transparent manner via Financial Management Information Systems (FMIS). Saxena and Stone (2020, p.3) do not suggest to bypass established controls but “**create a stream for handling priority items and fast track expenditure authorisations for the most prioritised measures.** There could always be tension between controls and efficiency, and a balanced approach should be taken”. Saxena and Stone (2020) mention several ways countries can do this, based on IMF experiences from PFM responses after a crisis:

- **Adopt a risk-based approach to controls.** For example, pre-audit can focus only on high-risk payments, while relatively less risky payments may be subjected to post-audit.
- Where feasible, give **greater delegation of financial authority** — both for reallocation of funds and payment approvals — to frontline ministries, such as the health ministry.
- Where possible, **use of a real-time gross settlement (RTGS) system** would enable moving funds swiftly across the country’s financial system. Such systems may be designed primarily for high-value transactions between financial institutions.
- **Direct deposits through banking channels or mobile payments and prepaid cards** for those without a bank account works the best for wage subsidies and cash transfers to large sections of affected population. These methods require advance preparation and cannot be used on-the-fly. Early action from the authorities—especially at the local level—will be critical for ensuring the efficacy of such mass disbursement systems.
- The biggest challenge will likely be the **beneficiary authentication and fraud prevention.** Governments will have to devise ways of ensuring timely relief disbursement with an acceptable degree of risk.
- Some governments may resort to **cash advances to make available resources to service delivery units promptly, especially if the normal disbursement procedures are cumbersome and take time.** It will be important to track and account for advances properly and ensure their utilisation and prompt settlement.
- **Coordination with subnational governments/entities will be important in understanding the needs at the grassroot level,** to provide the necessary funding to enable them to meet the enhanced service delivery requirements, and to improve the quality of response. A system of information exchange on funding needs of subnational governments, their liquidity position and implementation progress is necessary to for timely and accurate programme executions.

**Although some risk management in the implementation phase could be relaxed for some less risky spending, mechanisms should be in place to control and monitor risk exposure.**

Balibek et al. (2020) highlights the importance of an internal monitoring mechanism for regular review of: (i) the potential for risk realisation as new information becomes available; (ii) whether existing policies remain appropriate; and (iii) whether existing mitigation measures are adequate.

Furthermore, Balibek et al. (2020) mention the **importance of Parliamentary involvement in monitoring the guarantees given.**

## **PFM reforms and lessons in the oversight phase**

The challenge here is to ensure comprehensive and transparent reporting and public accountability procedures that existing oversight institutions (e.g. Parliament, the Supreme Audit Institution, independent fiscal councils), civil society, and the public at large are able to enforce while the new support measures are being designed and implemented (Wendling et al., 2020).

**Monitoring and accountability system should be independent and transparent focusing on both complying to fiscal rules, advising on any changes in such rules, and evaluating impact and quality of public investments.** This means regularly reporting on the progress in the implementation of the support package – both on and off-budget operations – and a focus on accessibility of information for the average citizen. Inclusion of civil society important, for example, ICEFI in Guatemala is monitoring the implementation of emergency measures and alerting government authorities to speed up administrative procedures for successful implementation (Wendling et al., 2020).

However, most governments in developing countries have not established an external oversight body tasked with monitoring compliance with their fiscal rules. The aims, mandates and limitations of these institutions vary depending on the legal, political and institutional environment of each country. The most common institutions are:

- **Supreme audit institutions** increasingly play a role in overseeing the fiscal framework, but only when fiscal rules are widely adopted (e.g. Brazil, India, Indonesia). They can play an important role in resource governance as they oversee compliance with rules across the whole extractive decision chain. They are well placed to monitor whether the law was followed and if budgetary and fiscal targets have been met. However, audits are protracted in time, often completed more than a year after budget execution, which hinders their ability to warn about impending risks (Mihalyi & Fernández, 2018).<sup>5</sup>
- Many **fiscal councils** were established after the GFC in 2008. Unlike audit institutions, fiscal councils generally conduct ex-ante evaluations of compliance with the rule through forecasts and provide inputs into the planning and policy formulation process (e.g., by estimating costs of measures), often making explicit recommendations on fiscal sustainability. Unfortunately, the technical expertise needed for a well-functioning fiscal council remains a challenge across low-income countries (Mihalyi & Fernández, 2018).
- A **parliamentary budget office's** role is to provide technical support to parliamentarians in their legislative and oversight functions. They often do this by supporting the work of

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<sup>5</sup> The Brazilian Federal Court of Accounts, the Tribunal de Contas da União (TCU), conducts inspections and audits on its own initiatives or by request of the National Congress. The house of representatives elects the audit board of the Republic of Indonesia, the Badan Pemeriksa Keuangan (BPK). The BPK provides periodic reports on state finance accountability, including periodic reports on fiscal compliance. It is established in the constitution and is independent from both the legislative and executive branches of government. In India, however, the president elects the comptroller and auditor-general members. The Indian audit institution's mandate is vague in respect of fiscal rules oversight, but it does report on compliance regularly (Mihalyi & Fernández, 2018).

the main budget committees, or evaluating or costing various new bills. Some also review compliance with fiscal rules.<sup>6</sup>

**In the cases where there is limited technical capacity but already one established institution working on public finance, it may be beneficial to build on it and expand its remit, rather than setting up a new institution** (Mihalyi & Fernández, 2018). Most common in developing countries is to establish a fiscal advisory council. For example, in Timor-Leste, Nigeria, Colombia, Peru, Brazil, Indonesia and Ghana independent fiscal advisory councils have been created to advise (non-binding recommendations) governments and legislators in the management of their resource wealth and related fiscal policy formulation and implementation. To cite Sharma and Strauss (2013, p.15): “Opening up fiscal policy to scrutiny by an independent body is a good practice of fiscal transparency, which puts pressure on the government to be honest. Enshrining independence in legislation is considered an effective means of demonstrating political support for a fiscal council”.

**Typically, fiscal councils are government or legislative agencies mandated to provide independent advice on and/or verify fiscal policies, plans and performance** (Hemming, 2013; Hemming & Joyce, 2013). Many fiscal councils must, as part of their mandates, check compliance with fiscal rules, although they cannot prevent governments from actually breaking these rules. However, the literature also mentions that too much pressure from fiscal councils on governments could undermine the credibility of the government and draining scarce resources from the government (Sharma & Strauss, 2013). While the mandate of fiscal councils differs among countries, no council has been granted the power to set fiscal targets or change taxes, as this would raise serious issues of democratic accountability (Ossowski & Halland, 2016).

Empirical evidence on the usefulness of fiscal councils in developing countries is still sparse (Hemming, 2013). However, Mihalyi and Fernández (2018) research shows **overall countries with national independent oversight bodies are more likely to follow fiscal rules than countries with no formal oversight**. Colombia, Indonesia (Annex 4 shows how this PFM reforms can be directly related to the Asian Financial Crisis of 1997-98) and Peru are all examples of countries with strong oversight bodies publishing yearly reports on fiscal rule compliance. But fiscal councils require capacity and strong governance structures, which may be difficult to establish, especially in low-income countries (Ossowski & Halland, 2016).

#### **Box 1. Earmarking**

Some countries have utilised strict earmarking practices to channel revenues to particular budget items. This often happens in resource-rich developing countries, and/or often in the aftermath of a crisis to secure specific spending in a constrained budget. However, **evidence from research shows that long-term “earmarking generally reduces fiscal flexibility and is open to capture from special interests, leading to underinvestment or overinvestment”** (OECD, 2018, p.19). The OECD (2018) report mentions several disadvantages to earmarking:

- It can constrain budgetary flexibility.
- It may lead to government inefficiency, and overinvestment or underinvestment in certain public services.
- It may contribute to procyclicality of public expenditure.

<sup>6</sup> The Centro de Estudios de las Finanzas Publicas (CEFP) in Mexico is an examples of parliamentary budget offices. It is not legally mandated to monitor compliance with the fiscal rules. Nevertheless, CEFP started publishing quarterly public finance reports in 2016, which can be used to monitor the rules.

- It can be fashioned such that it is not subject to parliamentary oversight. This may undermine public financial management and public investment.

**Ecuador in the start of the 2000s is mentioned as example how earmarking can go wrong** (e.g. OECD, 2018; Ossowski & Halland, 2016). Although the government had in place fiscal rules and a stabilisation fund, on the other hand the budget process in Ecuador had been characterised by multiple competing interest groups, institutional instability, and limited incentives for long-term cooperation (Cueva & Ortiz, 2013). The complexity of the earmarking, and when and how deposits were made, constrained government's ability to prioritise spending efficiently. As such earmarking exacerbated spending pressures during the 2003-2008 oil boom (Lopez-Murphy et al., 2010). In 2008 the whole fiscal system was dismantled as it became clear that the schemes favoured debt repayment rather than social spending (Arrellano-Yanguas & Mejía Acosta, 2014).

**On the other hand, Botswana and Indonesia are mentioned as countries that to some extent earmarked resource revenues, but without relying on strict and complex statutory expenditure requirements.** Both countries 'earmarking' has been linked to a clear governmental development policy agenda approved by parliament. Both countries successfully combined sound macroeconomic management with clear long-term development policies, which was the basis for increased productive investments in human capital and infrastructure. Development spending was stable over a long period as the stabilisation fund ensured continued spending in downturn periods (OECD, 2018).

### 3. Other lessons learned

Some general lessons on PFM interventions and reforms after a financial crisis mentioned in the literature, are:

- **While the debate about which specific risk management techniques are best suited to the public sector continues, there is general agreement that governments need to better understand the financial impacts of current policies and future unexpected events.** For the South-East Asian countries with some risk management measures in place due to reforms after the Asian Financial Crisis, this helped them during the GFC to act adequately and within their own terms without being too dependent on others (Sangsubhan, K. & Basri, C.M., 2012).
- **A lesson mentioned in Grant Thornton (2013) and drawn from the GFC is that many governments did not sufficiently employ risk management into their PFM practices.** As a result, they were forced public assumption of previously private indebtedness, and dramatically impacted revenues and trade flows. As these lessons have become clearer, discussions on risk management techniques relevant to the public sector have become part of the PFM debate.
- **The AFC showed the importance of expansionary fiscal responses in the short-term, to mitigate the immediate threats. This was tested again during the GFC in which most developing countries were able to turn the tide supported with some stimulus packages combined with PFM reforms.** The AFC also showed that the initial reform packages focussed too much on structural reforms while these could be better dealt with in the medium-term to give priority to short-term crisis management to support actions to protect the most vulnerable with food supplies with direct transfers and subsidies, generating income through cash transfers and public works, while giving business temporary tax cuts (e.g. Doraisami, 2011; Sangsubhan, K. & Basri, C.M. 2012; Ariadharma, E. & Purnomo, H., 2018).
- **ILO et al. (2011) show clearly that it is difficult for fiscal stimulus to be effectively implemented in timely, targeted, and temporary manner because of the political**

**process that precedes the delivery of the stimulus. Such fact points to the need for enhancing the scope and effectiveness of automatic stabilisers**, the fiscal policy tools that respond immediately and symmetrically to business cycle fluctuations.

“Automatic stabilisers have a natural advantage over discretionary policy not only because they are automatically implemented and withdrawn but also because the public debt automatically remains stable over the business cycle. However, placing the right automatic stabilisers in the economy in advance to economic shocks is another policy challenge that countries need to ponder upon, particularly in consideration of their associated costs”, state ILO et al., (2011, p.6). While automatic stabilisers have an important place in combating economic fluctuations, it is often difficult to optimise these tools and place them in advance.

- **Even in the most favourable of circumstances, the scale and complexity of the tasks to be undertaken are enormous, requiring levels of coordination and collaboration that may be without precedent for those involved** (Woolcock et al., 2018). Entirely new skills—for example, learning to use sophisticated software—may need to be acquired by tens of thousands of people. “Such reforms are often premised on the need to “modernise” prevailing administrative systems, with the long-run payoff being enhanced efficiency and effectiveness in the collection, management and allocation of public resources, all in pursuit of top-priority national strategy objectives”, state Woolcock et al. (2018, p.1).
- **These payoffs may take many years to fully materialise, requiring sustained commitments from senior officials as set-backs, delays and confusion threaten to sap morale and momentum** (Woolcock et al., 2018). High turn-over, competing distractions and inherent uncertainty can compromise the necessary focus. As such the pace and coherence of PFM reforms is important where reforms are to be undertaken incrementally. Adaptation, allowing some form of experimentation within pilots for innovative measures, and an incremental, gradual approach is often the best way forward in emerging economies and developing countries, in particular when PFM reforms are combined with decentralisation processes. “Even where the political context for reform is very supportive, care needs to be taken in designing the technical aspects of the programme to ensure that reforms do not become the unmanageable victim of their own momentum”, state Woolcock et al. (2018, p.9).
- **Fiscal rules can only be effective if accompanied with procedural rules to avoid too much ‘creative accounting’**. Researchers refer not only to *‘numerical fiscal rules’* but insist to combine them with *‘procedural fiscal rules’* that “stipulate the principles and associated practices of transparency and accountability that should guide the design and implementation of fiscal policy” (Sharma & Strauss, 2013, p.9-10). Typical procedural rules include: a ‘hierarchical’ budget formulation process, for example, where more power is given to the Ministry of Finance than to the line ministries; transparency requirements in the budget document; and distinct amendment rules for budget formulation and approval (Sharma & Strauss, 2013).
- **Because many low-income countries have no robust PFM and PIM systems in place, they could follow a policy guideline (instead of fully implementing a fiscal policy framework) to enhance fiscal discipline without formally committing to a specific fiscal framework** until it has gone through a learning process and has established better PFM and PIM systems (Sharma & Strauss, 2013).

- **Other lessons for longer term PFM reforms are to learn about what works through an iterative process.** However, there is a risk that if a rule or commitment is broken the government could lose credibility. Furthermore, choose a **simple framework that is easily understood and straightforward to monitor**. This approach is generally preferable to a complicated structure that is less transparent (Mihalji and Fernández, 2018).
- **Needs to achieve goals of reforms are mainly concentrated on technical assistance, legal frameworks, and capacity building of employees. As such most emphasis in reforms is on building internal transparency, control, and capacity systems. However, there is less focus on strong public pressure for change.** Increased involvement or awareness of citizens is not an important driver of PFM reform (Grant Thornton, 2015). There seems to be a widespread lack of popular engagement with PFM reforms, while governments need trust from the society in their fiscal responses to crisis. Some developing countries look for engagement with the public on PFM reforms (Grant Thornton, 2015):
  - In August 2014, the Indian Government launched the Pradhan Mantri Jan Dhan Yojana (PMJDY), described as the world's biggest financial inclusion initiative. The scheme created 180 million new bank accounts in its first year and is expected to improve, not only personal finance practices, but also the efficiency of public subsidy and welfare programmes, and ultimately PFM engagement.
  - The Philippines government that has initiated 'Grassroots Participatory Budgeting' to identify the public goods and social services needed by communities. The priorities that emerge inform the budget of the relevant agency. In its 2015 national budget, the Philippine government included a total of US\$460 million for projects identified through the Grassroots Participatory Budgeting process.
  - A similar mechanism is in place in Kenya, where laws have formally established citizen participation opportunities in both budget formulation and approval. Some organisations now aim to coordinate this participation. The Institute of Economic Affairs, for example, consult with the public across Kenya and publish a consolidated 'Citizen's Alternative Budget' to influence the drafting of Kenya's budget policy statement.

## Annex 1. PFM interventions and Covid-19

**Governments around the world have been responding to the current Covid-19 crisis to provide massive fiscal support packages to address the adverse impact of the Covid-19 pandemic on people and firms.** Governments are in urgent need to identify fiscal frameworks for emergency cash flows during a time of significant market volatility and increasing operational risks due to safety and health risks in workplaces. Tools to access liquidity as quickly as possible to manage unanticipated cash flows are available, although not for every country under the same conditions, such as increased issuance of short-term treasury bills in financial markets, contingency credit/repo lines from commercial banks, overdraft facilities from central banks, and cash buffers built-up over the past years.

Conditions for access to such facilities and the management of cash buffers depend heavily on good government financial management. Furthermore, **beyond seeking access to cash flows in a crisis, adequate implementation of fiscal stimulus packages and measuring their**

**efficiency are all in need of well working PFM systems.** However, PFM reforms are “not just about money: to be successful in addressing a crisis, government policy responses aimed at safeguarding people and firms require building public trust, confidence, and support”, write Manal Fouad, Gerd Schwartz and Claude Wendling, all working for the International Monetary Fund (IMF) Fiscal Affairs Department, in a recently published post in the IMF PFM blog.<sup>7</sup>

The IMF has also published a *Special Series on Fiscal Policies to Respond to Covid-19* (next to PFM blog post on Covid-19),<sup>8</sup> with several publications to share information and good practices.<sup>9</sup> As Sandeep Saxena and Michelle Stone of the IMF Fiscal Affairs Department write in their IMF PFM blog post, in general, governments need to ensure that their PFM system is equipped to meet the additional requirements and new challenges in terms of:<sup>10</sup>

- **Delivery of emergency health services**, supporting provision of health care to patients, the purchase of supplies, equipment, and human resources to monitor, contain and mitigate the outbreak of Covid-19.
- **Ongoing delivery** of essential services that may come under stress during an outbreak.
- **Supporting new fiscal policies** to assist sections of the population in financial hardship.
- **Continued operations** despite the absence of PFM staff across government.

According to Vitor Gaspar, W. Raphael Lam, and Mehdi Raissi, also working for the IMF, there are three guiding principles countries should follow:<sup>11</sup>

- **Target support to households** to ensure access to basic goods and services and to a decent standard of living. To avoid permanent scarring, target support to viable businesses to limit layoffs and bankruptcies.
- **Deploy resources temporarily and efficiently** and reflect the costs in multi-year fiscal reports.
- **Assess, monitor, and disclose the fiscal risks** because not all measures will have an immediate effect on deficits and debts. For example, government guarantees extended on business loans may have no upfront costs but will fall on the government accounts if businesses fail to honour their obligations in the future.

**However, emerging market and developing economies typically have less room in the budget to respond.** They face multiple shocks: health crisis (high demand for health care and related costs), economic crisis (a steep drop in demand from abroad for their goods and services, plunging commodity prices), a financial crisis (capital flight, and higher borrowing costs in financial markets). **Also, they have relatively less developed tax-benefit systems.** In such a context they design, implement, and monitor their interventions (e.g. stimulus packages). An

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<sup>7</sup> IMF PFM blog post published on 22 April 2020: <https://blog-pfm.imf.org/pfmblog/2020/04/-do-whatever-it-takes-but-keep-the-receiptsthe-public-financial-management-challenges-.html>

<sup>8</sup> To follow the IMF PFM blog on Covid-19 articles see <https://blog-pfm.imf.org/pfmblog/useful-pfm-links-other-links.html>

<sup>9</sup> See: <https://www.imf.org/en/Publications/SPROLLS/covid19-special-notes>

<sup>10</sup> IMF PFM blog post published on 13 March 2020: <https://blog-pfm.imf.org/pfmblog/2020/03/preparing-public-financial-management-systems-to-meet-covid-19-challenges.html>

<sup>11</sup> IMF PFM blog post published on 17 April 2020: <https://blog-pfm.imf.org/pfmblog/2020/04/-fiscal-policies-to-contain-the-damage-from-covid-19-.html>



interesting read on these issues could be Mark Miller – from the Overseas Development Institute (ODI) – who recently published an overview of top reads on fiscal responses on Covid-19.<sup>12</sup>

In countries like India and Kenya, cash transfers made with the help of unique identification systems and digital technologies, or in-kind provision of food and medicine, such as in Bangladesh, are options that governments look for to tackle the crisis. China offers temporary tax relief for the most-affected people and firms, including in transportation, tourism, and hospitality services.<sup>13</sup> CABRI has published a *Covid-19 Africa Public Finance Response Monitor* that provides an overview of expected financing gaps and how African governments are responding to expenditure reprioritisation, efficiency gains, resource mobilisation, social assistance, business support, and monetary and macro-financial policy measures.<sup>14</sup>

## Annex 2. Short-term fiscal responses to a financial crisis

Figure 1 shows (based on an ILO et al. 2011 study) that **as a percentage of 2008 GDP countries in Asia, Pacific, Africa and the Middle East spent the most on fiscal stimulus packages as a response to the GFC**. Despite the difficulties to determine the exact size of stimulus packages,<sup>15</sup> data shows that countries in the Asia and the Pacific region (not including Japan and Korea) spent 9.1% of their 2008 GDP on stimulus efforts (weighted average by country size). **China was the main driver of the stimulus spending in Asia** as it had a stimulus package worth 12.7% of its 2008 GDP (ILO et al., 2011). Khatiwada (2009) also did a study on global fiscal stimulus packages as a response to the GFC. The study divides the **fiscal emergency responses** into:

- Increasing spending on public goods and services (e.g. infrastructure, education, health).
- Fiscal stimulus aimed at consumers (e.g. personal income tax cuts, cash transfers).
- Stimulus aimed at firms (e.g. corporate tax cuts).

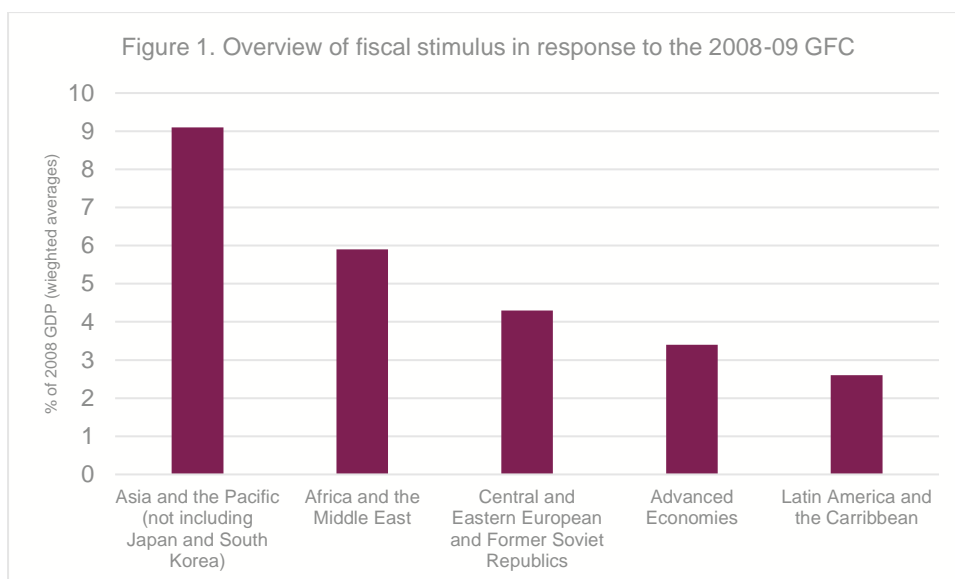
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<sup>12</sup> See <https://www.odi.org/blogs/16912-public-finance-and-development-top-things-read-fiscal-responses-covid-19>

<sup>13</sup> Examples come for Vitor Gaspar, W. Raphael Lam, and Mehdi Raissi IMF PFM blog post published on 17 April 2020: <https://blog-pfm.imf.org/pfmblog/2020/04/-fiscal-policies-to-contain-the-damage-from-covid-19-.html>

<sup>14</sup> See CABRI website for Public Finance Response Monitor <https://www.cabri-sbo.org/en/pages/covid-19-public-finance-monitor>

<sup>15</sup> ILO et al. (2011, pp.4-5) state: "It is important to note that there are several issues concerning the economic stimulus packages. First, the breakdown of rescue efforts in terms of old spending (already on the pipeline) and new spending is uncertain and unclear. Second, the time-horizon in which the stimulus package will be administered is also questionable. [...] Third, most countries have announced fiscal rescue packages different from their financial rescue packages, but there is a tendency to count in financial help to different sectors (like loan guarantees) as part of the fiscal package. [...] And fourth, some countries have announced stimulus spending embedded in their annual budgets, which makes it difficult in separating new spending from the old ones".



Source: ILO et al. (2011), [https://www.ilo.org/wcmsp5/groups/public/---dgreports/---inst/documents/publication/wcms\\_194175.pdf](https://www.ilo.org/wcmsp5/groups/public/---dgreports/---inst/documents/publication/wcms_194175.pdf)

**Infrastructure projects** generally focus on building and repair of roads, bridges, railway lines, and rural infrastructure with attention given to projects in the pipeline (e.g. China). China and Thailand also announced measures to increase home availability (through public housing projects) for poor households, while China and Saudi Arabia have announced significant increases in education and health spending with some school and hospital constructions as part of rural development programmes. Emerging economies and developing countries fiscal stimulus responses after the GFC were largely directed through increased spending on public goods and services (ILO et al., 2010; Khatiwada, 2009).

**Tax cuts** aimed at consumers fall into two categories: income tax cuts and sales tax cuts such as VAT reductions. Countries have also adopted tax cuts to boost sales in certain sectors, such as automobiles in Brazil.<sup>16</sup> Some countries, mainly high-income countries, but also some higher-middle-income countries (e.g. Mexico) had special measures to support house owners. China, Indonesia, Mexico, and the Philippines, amongst many other countries, announced increases in **social transfers** aimed at poor and low-income households. Social transfers include direct cash transfers, conditional cash transfers, and social welfare programmes.<sup>17</sup>

In terms of **fiscal stimulus aimed at firms**, stimulus packages have emphasized the viability of large firms, especially in the financial and automotive sectors. However, some countries also explicitly targeted SMEs (e.g. Mexico, Indonesia). In addition, public investments in

<sup>16</sup> In Brazil the reduction in the industrial production tax (IPI) gave an important boost to job creation due to the strong employment content – both forward and backward linkages – of the automobile industry. The initiative is estimated to have saved up to 60,000 jobs and the Instituto de Pesquisa Econômica Aplicada (IPEA) estimates that each R\$1.00 spent on cars has a multiplier effect of R\$3.76 on aggregate output. (source: ILO et al., 2011.)

<sup>17</sup> ILO et al. (2011) mentions a new social protection scheme in Argentina aiming at bringing children whose parents are unemployed or work in the informal sector and as such have not been covered by family allowances. The programme consolidates the transfers already provided through different social programmes into one major child benefit programme. When the programme achieves universal coverage, the total cost of the non-contributory component would equal about 1% of GDP. At the end of 2009 the programme included child benefits to unregistered workers earning less than the minimum wage, the unemployed, domestic workers and self-employed workers with very low incomes. In 2009 already 2.7 million children and adolescents were registered, about 55% of the total target population. Of these, 1.34 million were not previously receiving any social transfer payments (source: ILO et al., 2011).

infrastructure, construction and housing provided new market opportunities for SMEs as localised projects targeted local providers (e.g. Indonesia). Brazil also introduced special measures to support farmers.<sup>18</sup>

**Social transfers and employment measures (training programmes, job matching, funding for employment services) measured as a percentage of the total stimulus spending, is often small in developing countries and emerging economies** (6.8% for social transfers and 0.2% employment measures) (Khatiwada, 2009). Mostly the employment element of interventions relates to the creation of jobs/income through infrastructure projects. Although small in percentage, most employment measures target an **extension of unemployment benefits** (e.g. Chile, Brazil, Turkey, China), for example to more generous systems of unemployment benefits for temporarily laid-off workers.<sup>19</sup> Other countries like South Korea, the Philippines, and Thailand announced country-specific **measures to assist vulnerable workers**.

The study by Khatiwada (2009) and ILO et al. (2011) particularly show a clear distinction between developed and developing countries. **Advanced economies focussed mostly on tax cuts while developing and emerging economies focussed on infrastructure spending.** The fraction of stimulus going into infrastructure spending is three times higher in developing and emerging economies compared to that of the advanced economies. Meanwhile, tax cuts comprise over one-third of fiscal stimulus in advanced economies, while they comprise only 3% in developing and emerging economies, mainly due to the large informal economy that is excluded from such measures (Khatiwada, 2009).

The ILO et al. (2011) study states that **Asia's sharp recovery after the crisis was not only due to their financial system being spared as the crisis was mainly economical, but also that it owes much to the sizable and effective fiscal stimulus measures implemented by the region's governments.** For example, domestic spending has bounced back because the fiscal stimulus in the region was bigger and worked faster than in the West. To cite ILO et al. (2011, p.18): "Although monetary policy also contributed to the recovery in some countries, fiscal policy is likely to have played a greater role since it has a more direct effect on aggregate demand. Tax cuts and higher government spending were directed solely toward reviving sagging demand."

One important note that the literature makes, in particular, related to South-East Asian recovery, is that **the effectiveness of fiscal stimulus measures in developing Asia was based on a relatively healthy state of government finances as such financial stability allowed governments to implement the sizable fiscal expansion after the GFC.** For a large part this was due to the lessons learned from the Asian Financial Crisis ten years earlier (1997-98) after which several, mostly South-East Asian countries changed direction and established PFM reforms (e.g. strengthened fiscal rules and control). See later in this report the Indonesia case study. Also, the IMF states that developing countries with lower public debt and better budget

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<sup>18</sup> In Brazil one of the measures aimed to provide direct support to employment was directed towards rural farming – representing 16% of the labour force. The Government announced the Plan Safra 2009/2010 that granted R\$107.5 billion (US\$59.4 billion) to 4.1 million rural units, among which R\$15 billion (US\$8.3 billion) was allocated to family farms. The aim of the funding was to address credit constraints, enhance diversification and strengthen insurance against price declines.

<sup>19</sup> For example, ILO et al. (2011) mention for Brazil a number of automatic stabilisers that were reinforced during the crisis. In addition to existing social assistance programmes, there was an extension of unemployment insurance benefits by two months for redundant workers employed in sectors most affected by the crisis.

balances for many years prior to the GFC managed adequately the economic downturn with substantial fiscal stimulus packages.<sup>20</sup>

In Asia, it was mostly India and the Philippines that had high debt ratios before the GFC. Even with some limitations in fiscal space, the **Indian government** announced three rescue packages in 2008 to help the economic recovery – with a total of over 3% of GDP 2009 (Kumar & Soumya, 2010). These have been largely in the form of a reduction in taxes and duties (across the board 4% cut in central VAT, aimed at bringing down the prices of both consumers' as well as producers' goods such as cars, cement, textiles and others) and, to some extent, incentives to the export sector (interest subsidy on export finance, a refund of excise duties and central sales tax, other export incentives, and a 2% reduction in central excise duties and service tax) (Kumar & Soumya, 2010). The main focus was on SMEs and special measures were taken to priority sector as the garment industry. The government and Parliament had allowed the fiscal deficit to expand beyond the originally targeted levels both in 2008–2009 and in early 2009–2010 to give fiscal space to these stimulus packages (Kumar & Soumya, 2010).

Other countries, like **Bangladesh**, did mostly the same to support domestic demand (poverty alleviation and implement social safety net programmes to increase aggregate demand, plus micro credit programmes) and their most strategic export sectors (bonded warehouse facilities through which the exporters can import duty-free fabrics and other raw materials; duty draw-back facilities which are extended to those who cannot avail bonded warehouse facilities; providing 5% of the export value to those who use local yarn and fabrics to make their products; and a zero tariff on imports of cotton in the interest of yarn producers) (Bangladesh Ministry of Finance, 2010). In addition to fiscal and financial package the Bangladesh government has taken policy support and administrative reform plan which were implemented simultaneously (Bangladesh Ministry of Finance, 2010).

For **Sub-Saharan African (SSA) countries**, the situation was different. Like in Asia, the GFC had caused a serious economic downturn for most countries on the continent. The global financial and economic crisis hit the continent mostly through real channels, such as deteriorated terms-of-trade, reduced demand for exports, decline in FDI, remittances, tourism, and possibly also aid inflows (Kasekende et al., 2010). As a result, commodity, mineral and oil-exporting economies were hit hardest in the region. However, as Kasekende et al. (2010) shows, **oil-exporting countries were also the countries with the highest reserves to respond to the GFC**. Four years before the crisis (2005 – 2008), African oil exporters posted a substantial current account surplus of 11% of GDP and a fiscal surplus of 6.7%. Several countries, such as Angola, Botswana and Nigeria used reserves to insulate their economies from the early impact of the crisis. In contrast, oil importers recorded current account deficits of 5% of GDP and fiscal deficits of 0.6% during that period. Some countries, especially the fragile and post-conflict states, lacked the policy space for counter-cyclical measures that could ease recovery (Kasekende et al., 2010).

However, **other than Asian governments, most SSA governments face the challenge of limited fiscal space to manage fiscal stimulus effectively**. Barrell et al. (2009) also suggest that a fraction of stimulus efforts in the developed economies would have significant positive effects in SSA countries if they were implemented in the region. Furthermore, **fiscal policies**

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<sup>20</sup> See: Emerging Market Countries and the Crisis: How Have They Coped?, IMF. 2010.  
<http://blogimfdirect.imf.org/2010/04/19/emerging-market-countries-and-the-crisis-how-have-they-coped/>

**have not had the same degree of positive effect on job growth as they did on GDP growth in SSA** (“jobless growth”) (ILO et al., 2011).

Some examples of African countries that had the fiscal space to seek expansionary policies, are Kenya, Tanzania and Uganda (Kasekenke et al., 2010).

- In **Kenya**, government expenditures in 2009-10 increased by about 25% relative to the previous year, while the fiscal deficit (after grants) is reached 6% of GDP. Measures to stimulate the economy included a reduction of VAT on electricity, the removal of duties on maize and related products, as well as a public works programme.
- **Tanzania**’s healthy fiscal space (provided by low public debt and adequate reserves) allowed accommodating policies with the highest stimulus package in SSA.<sup>21</sup> Government expenditures on infrastructure (road and energy projects) increased in the 2009 -10 budget by about 30%. At the same time, the country adopted fiscal measures to raise tax revenues, including through widening the tax base and revoking various exemptions.
- In **Uganda**, past prudent economic policies also provided scope to implement counter-cyclical fiscal policies, and in particular to raise expenditures in the 2009-10 budget by about 20% relative to the previous year. The package aims at supporting infrastructure and agriculture.
- **Botswana**’s government faced a collapse in exports, which prevented the government from considering a major stimulus package. But the government has sustained support of the private sector through infrastructure development, paid through build-up reserves.
- In **Mauritius**, the government adopted an expansionary budget for the 2008-09 fiscal year. The stimulus package amounted to 3.4% of GDP. Most of the expenditures went to infrastructure, but also financing education and raising the competitiveness of domestic-oriented industries and SMEs. In parallel, regulation of domestic prices of gas and oil made lower prices possible.

**More generally, most measures mentioned above in SSA also support longer-term growth.**

Furthermore, they are aimed primarily at the supply side and are accompanied by efforts to improve the business environment. Infrastructure projects are at the core of the countries’ response measures. Such steps are likely to encourage longer-term production and boost investor confidence. Second, while some of the packages contain demand measures (reduction of VAT rates, for example), these are limited in the African context (ILO et al., 2011; Kasekenke et al., 2010).

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<sup>21</sup> Information from Foresti et al. (2010) PPT titled “The global financial crisis: what role for state capacity and political incentives to respond to external economic shocks? Synthesis of literature review findings”. Retrieved from <https://www.gov.uk/dfid-research-outputs/the-global-financial-crisis-what-role-for-state-capacity-and-political-incentives-to-respond-to-external-economic-shocks-synthesis-of-literature-review-findings>

## Annex 3. PFM reforms in resource-rich developing countries<sup>22</sup>

The literature clearly states that governments in resource-rich developing countries, particularly with capital constraints, need to be careful not to fall into the trap to over-consumption and over-investment during periods of economic boom – as this inevitably results in a collapse in public spending when resource prices become low. To assure stable budgets over a longer period, fiscal policies must challenge short-term and middle-term pro-cyclical fiscal policies, boom-bust macroeconomic growth cycles, and sharp exchange rate appreciation that make non-resource exports vulnerable. This section of the rapid literature review therefore focuses on the efforts resource-rich developing countries take to build fiscal frameworks in which they embed their PFM reforms.

The literature (e.g. OECD, 2018; Ossowski & Halland, 2016) also mentions **four policy areas that need extra attention**: 1) fiscal rules within a clear fiscal policy framework, 2) sovereign wealth funds that are embedded within the fiscal policy framework and a macroeconomic strategy, 3) transparent and simple to manage expenditure arrangements, and 4) accountable oversight bodies.

The literature on fiscal rules shows that having a fiscal rule on itself is not enough to avoid the kind of macroeconomic challenges in times of crisis; it is merely the specific set of fiscal rules that are more relevant as based on country-specific needs, institutional capacity and exposure to external shocks (Sharma & Strauss, 2013). Therefore, fiscal rules should be accompanied by clear fiscal procedures that ensure decisions are accountable at all levels. It is often assumed that embedding fiscal rules in law ensures long-term political commitment, although Botswana is mentioned as a country with good compliance but without permanent fiscal laws (African Natural Resources Center, 2016). The advantage of embedding fiscal rules in law is that they become more difficult to alter when there is a change of governments. Legislation, particularly constitutional laws, is difficult and costly to amend.

**Research shows that in general most resource-rich developing countries do not comply with fiscal rules, and many do not even have them** (e.g. Mihalyi & Fernández, 2018).

Countries that comply with fiscal rules such as Botswana and Colombia used a structural or a non-resource balance rule that allowed them to continue with some controlled (extra) spending in downturn rather than pure budget balance or debt targets (which often result in austerity measures). However, as Mihalyi and Fernández (2018) conclude, the institutional capacity, fiscal reporting and statistical quality preconditions for adopting structural rules are very demanding. Some other information about how countries use their fiscal rules in times of crisis:

- Only **Peru** invoked a well-defined escape clause since 2013, rather than modify or break its fiscal rule. Although many countries have an escape clause for their fiscal rules, only Peru has specific operational guidance on how to activate the escape clause in event of a natural disaster or international crisis (Mihalyi & Fernández, 2018).

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<sup>22</sup> Information in this section comes exclusively from the K4D HDR No. 746: Quak, E. (2020). *Lessons from resource-rich developing countries about using their resource revenues for improved public service delivery*. K4D Helpdesk Report. Brighton, UK: Institute of Development Studies. <https://opendocs.ids.ac.uk/opendocs/handle/20.500.12413/15145?show=full>

- In the case of **Timor-Leste**, the fiscal framework has been put in place with a process of adaptation. The Timor-Leste authorities have followed a modified version of this fiscal framework, and thus designed the fiscal rule accordingly so that investment can be front-loaded to address the current development gaps. This process of changing and revising the fiscal rule has been accomplished through a consultative and transparent process that involved key agents (Sharma & Strauss, 2013).
- **Nigeria** has a flat three percent deficit ceiling, which it comfortably achieved in the oil boom years. However, the government allowed procyclical increases in spending during the resource boom, which in turn resulted in overall balances that did not generate significant savings. Ultimately, the government missed the ceiling after the oil price crash (Mihalyi & Fernández, 2018).
- **Colombia** adopted a fiscal rule in 2011 and was able to follow it in the economic downturn despite difficult economic times. This is because under its structural budget balance rule, Colombia had to adjust much less harshly than if it had an overall balance rule: both the structural oil price adjustment and the adjustment for the cyclical position of the economy provided additional fiscal room (Mihalyi & Fernández, 2018).
- **Tanzania** provides a good example of non-resource budget balance: the non-gas deficit limit is set at 3% of GDP, meaning that any gas revenue above and beyond that level needs to be saved for times of poor economic performance or until after gas revenues are exhausted (Mihalyi & Fernández, 2018).
- The fact that **Liberia** complied with its fiscal rule is unsurprising given how the rule is written. Liberia adopted a debt ceiling in 2009, the year before obtaining almost complete debt relief. With the debt ceiling set at 60% of GDP, while the country's debt shrunk to 30%, the debt rule was clearly too loose to provide any meaningful restrictions on government action. However, recent forecasts suggest that the debt limit now is coming increasingly close, which will soon put the rule to a more challenging test (Mihalyi & Fernández, 2018).

**Overall, the literature shows that fiscal rules should not be too rigid, but flexible within clear margins** (Mihalyi and Fernández, 2018). Capital scarce resource-rich developing countries should also be able to spend more money upfront, but within the confines of clear fiscal rules (e.g. Sharma & Strauss, 2013).

Sovereign wealth funds are becoming increasingly popular tools for managing natural resource wealth in developing countries (also called resource funds). Five different funds are mentioned in the literature: stabilisation funds, saving funds, finance funds, development funds, and strategic investment funds. **Such resource funds can support the implementation of sound fiscal policies.** Therefore, the establishment of a resource fund should be combined with a broader fiscal management framework that needs to be coherent, consistent, and disciplined (OECD, 2018). Implementing countries establish specific operational rules for managing their resource funds, covering accumulation, withdrawal, and investment decisions.

Evidence shows that sovereign wealth funds' success in resource-rich developing countries depends on commitment to fiscal discipline and sound macroeconomic management (e.g. diversification strategy, national development plan) (e.g. OECD, 2018; Ossowski & Halland, 2016). **For capital scarce developing countries, stabilisation funds must not be seen as supporting capital needs, because their investment policy must highlight safe foreign assets to ensure sufficient liquidity to counter price volatility in times of crisis, which can result in public criticism.** In this respect, transparency is an important tool, not just to report on

performance, but to build trust among the population that resource revenues are well spent (OECD, 2018).

Saving funds have a longer time horizon inherent (e.g. securing pensions even in times of financial and economic crisis) to the policy objective and in principle they afford a lower liquidity preference and a greater risk tolerance. **Evidence shows that saving funds' investment decision-making shielded from short-term political cycles drives better performance, that long-term value creation is contingent on the management of risk and uncertainty, and that policymakers should be aware that high-return projects in resource-rich developing countries are not immediately available** (Ossowski & Halland, 2016). Examples of countries that have established resource funds and successfully implemented the operational arrangements, at times through a process of adaptation, include Botswana and Chile. Countries that have been less successful in implementing resource funds include Chad, Nigeria, Venezuela, Ecuador and Algeria.

**The literature is clear to use controlled flexibility within the fiscal and withdrawal rules instead of rigid rules to control the funds.** The fiscal rules and the fund's operational rules may be mutually inconsistent in certain circumstances, leading to the need for difficult choices between compliance and avoiding inefficiency and fiscal costs. Chile's stabilisation fund is an example of a fund where flexible rules have contributed to its successful implementation, while Venezuela had poor experiences with resource funds because of changes to the fund's rules and deviations from the intended purpose.

Key learning points for improved management of resource funds, as mentioned in the literature, are an increased transparency, fiscal discipline, and capacity to manage funds. **Evidence shows that resource-rich developing countries need to integrate the management of the funds within broader Public Financial Management (PFM) and Public Investment Management (PIM) systems and integrate the funds within the national budget to ensure clarity** (Venables, 2016; Ossowski & Halland, 2016). Countries with weak institutional capacity and PFM and PIM systems should focus on one resource fund, possibly with two separate portfolios to meet stabilisation and savings objectives, rather than two separate funds (Sharma & Strauss, 2013). Some experiences of developing countries by using wealth funds:

- **Nigeria's** Excess Crude Account has played some role in stabilising the economy, but its effectiveness has been undermined by the failure of many state governments to ratify the federal *Fiscal Responsibility Act* that set up the fund; by the absence of sound legal foundation; and by "ad hoc disbursements". In 2011, Nigeria established the *Nigeria Sovereign Investment Authority* (NSIA) as an independent agency to manage the country's new sovereign wealth fund (a saving and stabilisation fund, and investment fund) (OECD, 2018).
- In 2012 the existing *Fonds pour les Générations Futures* was renamed the *Fonds Souverain de la République Gabonaise* (FSRG), and an agency was created to identify long-term investments for the FSRG, which would be a savings fund with investments in **Gabon**. Until the fund's capital reaches a pre-established minimum level, the fund will receive 10% of annual budgeted oil revenues, 50% of the difference (if any) between actual total budget revenues and the revenue projection in the budget, and dividends from public investments and state participation. Once the minimum capital level is reached, the FSRG will receive 25% of the income on its investments, and the difference between actual and budgeted oil revenues (Ossowski & Halland, 2016).



- **Cameroon** was initially praised for setting up an offshore (and extra-budgetary) account to manage oil revenues, but from which about half of Cameroon's total oil revenue subsequently disappeared. The overall record on stabilisation funds has been poor, with multiple episodes of boom and bust (Venables, 2017).
- **Ghana** established funds in its Petroleum Revenue Management Act of 2011 and deposited some revenues in saving and stabilisation funds. All oil and gas revenues go directly to the Petroleum Holding Fund. Part of the revenues is then reinvested in the Ghana National Petroleum Corporation (GNPC). Another share is allocated to the Ghana Petroleum Funds which serve the dual objective of saving for future generations (Heritage Fund) and smoothing the effects of commodity price volatility and sustaining public expenditure in periods of revenue shortfalls (Stabilisation Fund). The remaining share is channelled to the national budget through the Annual Budget Funding Amount and shall serve for spending and investment in priority sectors such as agriculture, education, health and infrastructure. But strong fiscal rules governing the small resource sector coexisted with lax budget rules elsewhere, allowing government current spending to increase dramatically, creating fiscal and external deficits that necessitated an IMF rescue programme early in 2015 (Ossowski & Halland, 2016)
- **Trinidad and Tobago** is one of the very few Caribbean countries with a natural-resource-revenue fund. The Heritage and Stabilization Fund (HSF) has well-defined objectives, a sound governance structure, and a relatively conservative investment portfolio. Nonetheless, inflow and outflows rules are not directly linked to fiscal indicator(s) or the sovereign balance sheet. Such rules need to be reassessed and more closely linked to a medium-term fiscal framework, improving its potential as a countercyclical tool. The fund should be considered within a sovereign asset-liability management framework (IMF, 2018).

Overall, the literature shows that linking the fiscal system with PFM and PIM systems is crucial to help avoid the risk that resource revenues are not spent irresponsibly and without consultation with relevant stakeholders (Sharma & Strauss, 2013). **Establishing a monitoring and accountability system that is independent and transparent, focusing on both complying with fiscal rules, advising on any changes in such rules, and evaluating the impact and quality of public investments, is also crucial.**

Empirical evidence on the usefulness of fiscal councils in developing countries is still sparse (Hemming, 2013). However, Mihalyi and Fernández (2018) research shows **overall countries with national independent oversight bodies are more likely to follow fiscal rules than countries with no formal oversight**. Colombia, Indonesia and Peru are all examples of countries with strong oversight bodies publishing yearly reports on fiscal rule compliance.<sup>23</sup> But fiscal councils require capacity and strong governance structures, which may be difficult to establish, especially in low-income resource exporters (Ossowski & Halland, 2016).

**In cases where there is limited technical capacity but already one established institution working on public finance, it may be beneficial to build on it and expand its remit, rather**

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<sup>23</sup> Norway does not have an oversight body for its rule, but the government did task a public expert commission to review compliance with the rule. Malaysia has no independent oversight, though it has an internal government body. Botswana and Liberia on the other hand have followed their fiscal rules despite not having formal oversight bodies (Mihalyi & Fernández, 2018).

than **setting up a new oversight institution** (Sharma & Strauss, 2013). Countries also increasingly make use of public consultation and building consensus (e.g. Timor-Leste, Ghana) for setting expectations around how the natural resource wealth will be managed, particularly regarding how much revenue will be available for current consumption and investment, and how much will be saved for future generations.

## Annex 4. Indonesia case study

**Indonesia is an interesting case as the country was one of the countries that was worst hit by the 1997-98 Asian Financial Crisis (AFC). The crisis highlighted the lack of efficiency, transparency, accountability, and control on state money in Indonesia.** Fragmented and overlapping structures in the Ministry of Finance were a major constraint, leading to inadequate fiscal discipline, poor resource allocation and unreliable fiscal reporting (Ariadharma & Purnomo, 2018). Indonesia went through a long process of PFM reforms after the AFC and as a result, amongst other reasons, was able to react adequate to the GFC in 2008-2009.

**The AFC put the spotlight on the abuse of the PFM system for personal gains of president Suharto's inner circle and the low capacity human resources in the management and use of public resources** (Ariadharma & Purnomo, 2018). The highly corrupt Suharto regime hesitated to modernise Indonesia into an open market economy with strong institutions built on improved transparency and anti-corruption measures in a time of shrinking budgetary resources due to the crisis and rising public expenditure needs. The result was that the financial crisis resulted in **the downfall of the authoritarian Suharto regime in 1998**, which included the collapse of the single-party political system.

**Indonesia engaged with the International Monetary Fund (IMF) longer than any of the other countries affected by the AFC.** Fund programmes were not terminated until 2003, six years and four presidents after their launch in late 1997. The international response on the AFC involved the signing of programmes including structural reforms in economy and governance in cooperation with the World Bank. As Martinez-Diaz (2006) shows, **dealing with different presidents in time of turning to democratic rule hampered the engagement with IMF, which already suffered from low confidence after the initial contractionary fiscal response.** Strengthening public sector governance and performance was thus a key imperative following the downfall of the regime in 1998.

### Short-term fiscal policy responses to the AFC

**Before the crisis, there was no effective legal framework for budgeting in Indonesia.** In fact, the process was essentially a continuation of the Dutch colonial budgeting system where the preparation of the budget was conducted internally by the Governor-General. **The process was characterised by a lack of transparency and accountability.** In such a context, Indonesia signed the Letter of Intent with the International Monetary Fund (IMF) in October 1997. The IMF programme for Indonesia was an IMF standard, consisting of the following measures (Nasution, 2000):

- a short-term stabilisation policy to reduce domestic absorption;
- medium-term economy-wide reform to remove economic distortions and improve efficiency;

- measures to strengthen market infrastructure (e.g., accounting and legal systems) to reduce asymmetry of information and transaction costs.

However, the Suharto regime became soon aware of the real impact of the measures for their own businesses and political power and annulled the IMF programme. This was combined with the devastating impact of the **contractionary fiscal policy** and IMF advice to **take over private sectors debts (bail-out policy)**. This policy had caused government debt to increase sharply and put up additional cost to government budget (Saparini, 2009). The IMF 'over-managed' the crisis, by demanding fiscal austerity and excessive policy conditionality, in addition to displaying a lack of political sensitivity at key periods (Hill, 2012). Consecutive governments, continued with the IMF programme after 1998, however, with some **relaxation to design short-term stimulus packages**, and worked on structural reforms with the World Bank.

Before 1997, the budget deficit had always been financed by foreign financial assistance, generally concessionary loans from official sources. Following the crisis, the authorities had to find other sources of revenue to finance the budget deficit. These new sources include revenue from **asset recovery** by the Indonesian Bank Restructuring Agency (IBRA), proceeds from the **privatisation of state-owned enterprises**, and flotation of **government bonds** in the domestic market (Nasution, 2000). The model of national assets selling without strategy had caused huge loss to the government as the recovery rate of assets was only 20% - far below that of South Korea at 47% and Malaysia at 57% (Saparini, 2009). The bank bailouts were financed mainly through off-budget mechanisms such as the issuance of recapitalisation bonds, which comprised a substantial portion of total public sector debt and entailed significant direct on-budget costs (Rosengard, 2004).

The authorities have also introduced various **measures to raise revenue from taxation** in the direct aftermath of the crisis. These efforts were met with limited successes because the tax system in Indonesia was inflexible, inefficient and less progressive (Nasution, 2000). Because of high debt, the government of Indonesia also **reduced subsidies in the longer-term**. Although the government has made significant reductions in the level of fuel subsidies in 2001 (and also in 2002, 2005 and 2008), these reductions were more than offset by rising international fuel prices, and the total expenditure on fuel subsidies increased significantly over the years (Blöndal et al., 2009).

To help the poor, in the absence of a modern social safety net system, the authorities provided **food and other basic needs at subsidised prices** and created **labour-intensive public works**. However, because of the lack of effective administration at the beginning, the subsidies did not reach the needy (Nasution, 2000). At the same time, the subsidies created large wedges between domestic and international prices of the state-vended products and provided incentives for smuggling to neighbouring countries.

The government also had to deal with high annual principal repayments and interest of US\$9 billion a year. To ease the pressures on the public budget and the balance of payments, the Paris Club creditor nations agreed on 23 September 1998 to **reschedule US\$4.2 billion in principal repayments of Indonesia's public external debt** (Saparini, 2009).

Several policy measures have been taken to **improve the governance system and reduce transaction costs** (e.g. Nasution, 2000; Blöndal et al., 2009; ADB, 2016):

- Completion of diagnostic studies of the complex government banking arrangements.
- Formulation of a reform strategy.

- Proposals to overhaul the inherited legal framework.
- Blueprint for Ministry of Finance reorganisation, including creating a DG Treasury.
- A review of government contracts was initiated to terminate those that were awarded through corruption, collusion, and nepotism.
- Licensing restrictions were reduced to increase domestic competition.
- The government also discontinued tax, trade, and credit privileges for national car and aircraft projects.
- State-owned enterprises were corporatised and privatised.
- The accounting and legal systems were strengthened to improve transparency and contract enforcement.
- The bankruptcy code was modernised.

## Longer-term PFM reforms after the AFC:

**PFM reform efforts included amending the constitution, promoting electoral reform, anti-corruption initiatives, public expenditure and revenue management reforms and decentralisation.** Many new laws were passed and new regulatory and monitoring institutions, required in a democracy and market economy, were established including a **powerful Anti-Corruption Commission (KPK)**. Such PFM reforms started in 2001 with the establishment of the **Financial Management Committee** initiated by the Ministry of Finance; it comprised leading bureaucrats, practitioners, politicians, and academics in Indonesia, and was tasked with guiding PFM reforms. A **White Paper published in 2002 articulated the need for comprehensive PFM reforms** covering the full PFM cycle and laid the foundation for enacting various laws to modernise the country's PFM at the central government level.

The **institutional reform phase between 2002 and 2005** included the segregation of roles between the finance ministry and line ministries and resulted in clarity on transparency and professionalism in public expenditure management. **In 2003, Indonesia adopted a fiscal rule which caps annual deficits at 3% of GDP and accumulated debt at 60% of GDP.** At that time, the government's deficit was 1.7% of GDP and debt was at 57% of GDP, and the economy was well on its path to recovery (Blöndal et al., 2009). There was a broad political agreement for the fiscal rule, reflecting the consensus that a stable macroeconomy was an essential framework condition for sustained growth. **A regulation, based on the law, interprets the fiscal rule to apply to both the central government and lower levels of government.** The new institutional structure also including **the establishment of a strong DG Treasury** and new laws — for budget management, planning, and treasury operations — were adopted by a **democratically elected Parliament** (IMF, 2007). The literature mentions the following new legal framework for budgeting and public expenses (Blöndal et al., 2009; Ariadharna & Purnomo, 2018):

- **The State Finances Law 17/2003**, which detailed the provisions for the budget process, mandates clear budget timetables, and established reporting requirements to Parliament, and introducing a medium-term expenditure framework system and performance-based budgeting.
- **The Presidential decree on Procurement (80/2003)** required improvements in the procurement regime and provided a timetable for establishing a national policy formulation and oversight agency.
- **The National Development Planning System Law (25/2004)** provided the legal basis for the national development planning process, and for linking planning with budgeting. It also set the role of the National Development Planning Agency (BAPPENAS).

- **The State Treasury Law 1/2004**, which outlined the responsibilities of the State Treasurer, articulates the creation of revenues and expenditures treasurers in government ministries and agencies, together with general principles on the management and accountability of public funds. The Treasury Law also envisages only one main operational account for government transactions, held at Bank Indonesia, the central bank. The objective is to transmit all government revenues into this account by the end of each business day and use it for making all government payments, without holding noninterest-bearing deposits in other government accounts.<sup>24</sup>
- **The Regional Governance Law 32/2004**, which replaced an earlier law from 1999. It outlines the responsibility of regional governments for a range of public services, including education, health, public infrastructure, agriculture, industry and trade, investment, the environment, land, labour, and transport.
- **The Fiscal Balance Law 33/2004**, which replaced an earlier law from 1999. It outlines the responsibility of regional governments for managing their public finances, their revenue-raising authority and the system of transfers from the national government.
- **The State Accountability and Audit Law 15/2004**, which paved the way to more accountable and transparent government institutions, obligating each of them to submit a financial report to be audited by Supreme Audit Institution (BPK) before being presented to the Parliament. The law establishes the operational foundation for the BPK as an external auditor to audit the management of and responsibility for state finance.

The IMF Survey (Lienert, 2007) mentions that during **the early implementation phase of these laws (between 2005 and 2006)** the Indonesian government achieved the adoption of a new accounting framework, testing of zero-balance arrangements for treasury-controlled bank accounts, and reaching a final agreement on remuneration and placement of idle government cash balances.

**Managing such reforms required high-level support and attention, dedicated human resources, sustained technical assistance support and a strategy that goes beyond the medium term.** Having recognised the task of such reforms the Ministry of Finance approached development partners, such as the World Bank and international donor countries for support to ensure the realisation of the envisioned long-term PFM reform goals. The World Bank supported Indonesia with Development Policy Loans, Investment Project Financing, PFM multi-donor trust funds, and technical assistance for policy advice (Ariadharma, E. & Purnomo, H., 2018). The World Bank also assisted to help sub-national governments to improve transparency, accountability and public participation practices (Ariadharma, E. & Purnomo, H., 2018). In 2004, the Ministry of Finance signed with the World Bank a package of loan, credit and grant agreements for the **“Government Financial Management and Revenue Administration Project”** (GFMRAP).

Within the GFMRAP it took time for the reforms to take place as building consensus among a large group of stakeholders took time. Initially, GFMRAP was planned to include three phases to be implemented over 12 years, tackling both public resource management and revenue

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<sup>24</sup> This had not been the case previously: powerful ministries, such as defense, obtained financing from substantial resources off budget. Smaller ministries, including even the ministry of religious affairs, as well as directorates of the MOF, also held accounts in commercial banks, outside the main operational account at Bank Indonesia.

generation. **Phase 1, which comprised the creation and roll-out of a new Integrated Financial Management Information System, called SPAN, was envisaged as an integrated state treasury and budget preparation system.** It was initially scheduled to take 4.5 years, but eventually took 11 years, due to delays in procurement and development of the IT software. Consequently, Phases II and III, dealing with revenue generation, were dropped halfway through, to focus on Phase 1 only (Ariadharma, E. & Purnomo, H., 2018).

**Key achievements of PFM reforms** established after the AFC include (Ariadharma, E. & Purnomo, H., 2018):

- **Curbing opportunities for corruption** by reducing the opportunities for discretion and informality that are more common in manual, paper-based systems. A key reform was the consolidation of cash balances from thousands of government bank accounts into a Treasury Single Account.
- **Improving transparency in payments** through electronic transfers to suppliers and employees replacing manual checks.
- **Improving the predictability of budget execution** and reductions in payment errors. Annual budget ceiling data is integrated with SPAN so spending units cannot disburse beyond this limit, helping strengthen expenditure control.
- **SPAN greatly improved access to information**, allowing not only the senior government officials to make better decisions about their program implementation but also for the line ministry spending unit staff to see their budget execution progress both on-line and in real time.
- SPAN has benefited the general public through the improvement of the **quality of audited financial statements** to reflect better transparency and accountability of the state's finances.

In 2007 the **Treasury Law** was reformed (Lienert, 2007):

- **Conducting a census of all government bank accounts** by end-2007. In its annual report covering the 2005 annual accounts of government, the external audit office (BKP) had found over 6,000 undisclosed accounts. In response, the Minister of Finance is taking actions to identify government accounts in commercial banks; ascertain who opened the accounts, when, for what purpose, and whether the account should remain open.
- **Securing agreement** by the Ministry of Finance and Bank Indonesia (BI) on the principle of remunerating excess government funds at the BI. An important objective for BI is to avoid the transfer of government deposits to commercial banks, which would increase bank liquidity and make monetary management more difficult.
- **Accelerating the deposit** of government revenues into the main treasury account and reducing lags for making transfers from the main treasury account in BI to DG Treasury's commercial bank accounts in its regional offices (KPPNs) (these accounts are used to pay suppliers of goods and services to government).

Besides specific treasury reforms, the government also started in 2007 (before the GFC) to implement other **budget management reforms**, including (ADB, 2016):

- Taking steps toward introducing a **performance-based budget system**;

- Introducing **medium-term budget and expenditure frameworks** (in the 2008 annual budget, aggregate revenues, expenditures and fiscal targets for 2008-2010 were presented for the first time);
- Identifying the main fiscal risks (a first-ever **statement of fiscal risks** accompanied the 2008 annual budget).

## Responses after the GFC

Hill (2012) states that the **fiscal prudence over the period 2000-08 meant that the government had re-established fiscal policy credibility and it had some scope for expansionary fiscal policies**. Hill (2012) and Basri and Rahardja (2011) also show that fiscal policy has been remarkably prudent since 2000, with successive administrations able to resist demands for greater spending and kept away from budget deficits for most of the time. **The only down-side mentioned in the literature due to prudent fiscal policies is that Indonesia has underinvested in infrastructural projects** (Hill, 2012). The reduction in public debt to GDP went from over 100% to less than 25% in little over a decade. This gave the government credibility in managing its public debt, and **room to move in its fiscal stimulus packages after the GFC in late 2008 and early 2009** (Hill, 2012; Basri & Rahardja, 2011).

The government established a **modest stimulus package** about 1.4% of GDP in 2009 (Rp71.3 trillion), considerably smaller than could have been justified by 'fiscal fundamentals' (Hill, 2012). The two main constraints were a lack of ability to quickly increase spending, particularly on infrastructure projects, and a reluctance on the part of the parliament to authorise significant increases in expenditure during an election year (Hill, 2012). The package addressed three major areas: income tax cuts, tax and import duty waivers, and subsidies and government expenditure (Basri & Rahardja, 2011). **The government focussed the fiscal stimulus on labour-intensive and domestic-oriented projects, aiming at three points** (Doraisami, 2011):

- Sustaining purchasing power to maintain household consumption.
- Maintaining corporate/business resilience.
- Creating employment and mitigating the impact of job losses through labour-intensive infrastructure construction.

**Aiming to stimulate more household and corporate spending, almost 60% of the Indonesian fiscal stimulus was allocated to tax cuts**. To minimise the effects of the global financial crisis, the government cut personal income tax from 35% to 30% and corporate income tax from 30% to 28% (Basri & Rahardja, 2011). The 2009 budget also announced a 15% **basic salary increase for civil servants, military personnel, police and pensioners**, and the payment of a 13th month salary. Complementing this was a **direct cash transfer** paid out to 18.2 million target households for two months at the rate of Rp100,000 per household per month (Doraisami, 2011; Doraisami, 2013).

In addition, around Rp2.5 trillion was allocated to finance **import duty waivers for raw materials and capital goods**. This was part of the Rp12.3 trillion tax and duty package, accounting for 18% of the total stimulus package, meant to support businesses (Basri & Rahardja, 2011). To help reduce operational business costs, the stimulus package also included **diesel and electricity subsidies**. Finally, close to Rp12 trillion was allocated to **support infrastructure and rural sector development** (Basri & Rahardja, 2011). To create jobs and mitigate job losses the government choose to focus on labour-intensive construction of infrastructure. They set up the **national community block grant (PNPM) programme** to invest

in projects in rural and urban areas (Doraisami, 2011). Much of the funding was broken into small grants that went to small local contractors and local labourers. To enhance the employment outcomes of the infrastructure component, the government has advocated **using local contractors, labour and resources** (ILO et al., 2011). Estimated was that 1 million jobs were created due to the stimulus package after the GFC (ILO et al., 2011).

**The Indonesian fiscal stimulus package faced challenges relating to the low number of individual and corporate taxpayers (large informal economy), the lack of targeted subsidies, and budget execution problems both in general and particularly in relation to infrastructure.** According to the World Bank (2007), actual budget performance in Indonesia has routinely deviated from budget realisation indicators. There is an overall problem with spending, and while budgets have become larger, the government has been unable to spend the money appropriated. Project implementation is disrupted by an adverse cycle, and in the case of multi-year projects, it is interrupted at the beginning of each year. This problem has worsened since Indonesia pursued decentralisation in 2001.

Initially the budget deficit was estimated for 2.6% of GDP in 2009, however, in reality the deficit was far lower at 0.1% of GDP (Basri & Rahardja, 2011). Indonesia, unlike other East-Asian economies is far less export-based and can rely on a large domestic market. For that reason, the GFC did not impact severely on the Indonesian market, while residents in commodity exports regions were capable of making use of their accumulated savings to fund consumption during the GFC. However, **Indonesia's PFM reforms contributed to such a stability that allowed them to be in control of the responses** (Hill, 2012).

**After the GFC the Indonesian government continued with a countercyclical fiscal policy.** It also continued with PFM reforms in particular to introduce medium-term expenditure frameworks (MTEF) and fiscal risk measures, **improve project executions and spending efficiency as lessons from the GFC.** Line ministries have formulated targets and indicators, which provide a better basis for evaluating the performance of programmes and activities in the coming years, thus fulfilling a fundamental prerequisite of PBB (ADB, 2016). **Targets, and indicators have been incorporated** in the five-year national plan (RPJM) for 2010–14, and first implemented in the FY2011 budget. These are the initial measures adopted in the planning and budgeting system in Indonesia in its **efforts to shift from “input based system to an output and outcome-based system”** (ADB, 2016).

ADB PFM assessment (2016) states further that the government in the aftermath of the GFC has created fiscal space via revenue mobilisation and energy subsidy reform to allow for **higher investment in infrastructure and social welfare programs.**



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