The capabilities of finance ministries

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Executive summary
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Executive summary

1. Introduction

All countries have a finance ministry. If one organisational feature defines what makes a state a state, it is a central unit that handles income and expenditure – or aspires to. This remains remarkably consistent irrespective of the huge variations in the purpose and institutional shape of government. Finance ministries are also at the centre of many current policy discussions, whether on how to respond to the 2008 financial crisis, how best to fund global development goals, or how an emerging economy should go about establishing a welfare state. Virtually every policy decision that involves the raising and spending of public money involves a finance ministry at some stage. Yet despite their almost self-evident importance, very few studies focused on finance ministries as objects of study.

How do finance ministries go about performing their tasks, what do they look like as organisations, and does it matter how they are organised? What makes a finance ministry capable of doing its job? Is it a strong legal mandate to run public finances as it sees fit? Is it a set of instruments that allow it to run public finance systems according to international best practices? Is it a group of highly trained, well-managed, diligent and dedicated people who keep the rest of the public sector in check? Is it a powerful minister who commands respect in cabinet and can overrule colleagues?

We have investigated these questions using multiple in-depth case studies: Germany, United Kingdom, Mexico, South Africa, Uganda, Nepal, and Sierra Leone. Each of the case studies covers institutional context, organisational features, and fiscal and social outcomes, as well as an analysis of capabilities. The cases were selected not randomly but to provide insights into what capability means in different contexts. Specifically, Uganda, Nepal, and Sierra Leone are all noted for having achieved considerable reform progress under difficult circumstances; South Africa, Germany, UK and Mexico were each considered at different times in the last two decades to be quite successful managers of fiscal performance; and South Africa's National Treasury is a notable case of a newly established ministry successfully taking charge of fiscal policy. The report also draws on detailed country-level case research from Viet Nam and Chile.

2. What is a capable ministry of finance?

Capability is more than capacity, defined as the total resource endowment of people and money, and manifests itself only in how it performs its tasks. Many reasonably well-endowed organisations fail to turn capacity into performance, while some manage to perform well on the basis of very scarce capacity. Underlying each task or function are four generic capabilities that, in varied combinations, make up an organisation's capability to perform these functions. These are (1) analytical, (2) delivery, (3) coordinative and (4) regulatory:

1. **Analytical capability**: the ability to understand and analyse information and research in order to inform decisions. In the case of finance ministries, this capability is in frequent demand in the recurrent formulation of all aspects of fiscal policy, as well as numerous more specific policy issues regarding the financial aspects of government activities. Many finance ministries pride themselves on the ability of their staff to master new policy briefs and counter the sectoral expertise of the ministries with which it negotiates funds. This capability is traditionally at the centre of many international efforts to provide technical assistance in developing countries, where the belief persists that better forecasting capability alone leads to more sensible fiscal policy.
2. **Delivery capability**: the ability to produce goods and services and get things done. For a central ministry that does not directly provide public services, this capability is less important than it would be in, say, the post office. Almost every finance ministry does, however, produce a set of landmark deliverables each year, in particular a complete budget according to (in most countries) a specific calendar. There are also more administrative tasks, such as revenue collection and cash management, which essentially rely on the ability to produce certain outputs – and often funding – across government.
3. **Coordinative capability**: the ability to orchestrate the activities of different actors in pursuit of a common objective. Coordination is a critical function of a finance ministry from its location at the centre of government. A vast range of policy activities can come together only if the finance ministry is able to assemble and use

specialist inputs from other ministries and bodies as well as non-government actors. Again, the best example is the setting of fiscal policy culminating in formulating the annual budget. This could not be achieved in a modern government without the organisation of vastly complex procedures involving many different actors who have to deliver, analyse and move along many components before the budget is complete.

4. **Regulatory capability:** the ability to control the production of particular services provided by others. Salient regulatory domains for many finance ministries include the oversight of state-owned enterprises (SOEs) and financial markets, but in a broader sense, regulation is also involved when finance ministries set the financial framework of spending ministries. In many countries, the finance ministry also has a major role in overseeing subnational entities in various aspects of public finance including debt management, performance management and fiscal aggregates. In countries heavily influenced by New Public Management (NPM), governments have sought to retreat from the direct provision of goods and services towards a more regulatory stance, which has affected finance ministries in various ways. Notably, it has led to a substantial increase in subordinate agencies reporting to finance ministries, accompanied by a downsizing of those ministries.

Finance ministries cannot perform their functions in isolation given that they are in charge of but seldom spend public money. The vast bulk of government financial operations happen elsewhere, so without means of interacting with and reaching into other organisations, it is impossible to exercise control from the centre, however powerful the formal mandate.

Finance ministries in the structure of government

No ministry is independent of the government and the institutions that surround it. This especially applies to finance ministries, which are mandated to exercise broad control over government financial operations rather than having their own expenditure. The relationship between organisation and environment is inevitably complex.

There is generally a strong correlation between per-capita income and virtually any measure of the quality of government. An assessment of capabilities therefore needs to take into account broad income levels. At the same time, the challenges facing the finance ministry also change with income. This was certainly the case historically, but it also seems to apply to countries today. For instance, the allocation choices facing a mature industrial economy with large entitlement programmes, ageing populations and entrenched bureaucratic interests are not the same as those facing a fast-growing middle-income country (MIC) without a fully developed welfare state. Given a certain income level, the precise shape and form of the institutional environment determines how much space a ministry has to develop its functions. Clearly, a weak legislature is much less likely to constrain a finance ministry's ability to set the terms of the fiscal policy process, for good or bad (see figure 1).

Figure 1: Legislative budget authority versus executive control between 'for good and bad' and 'ultimately'

Sources: Wehner (2006) and Krause (2009)

Ultimately, these institutional qualities are likely to affect how the ministry of finance is organised and how effectively it can perform its functions. Very rarely is a finance ministry so constrained in its mandate that it would be considered a backwater. Limited mandates on their own also do not make it hard to maintain capability. This seems to be generally true even in countries where the finance ministry has severely constrained powers, such as in the United States. The functional core of the finance ministry always appears to be sufficiently strong to merit a degree of executive attention.

Finance ministries as organisations

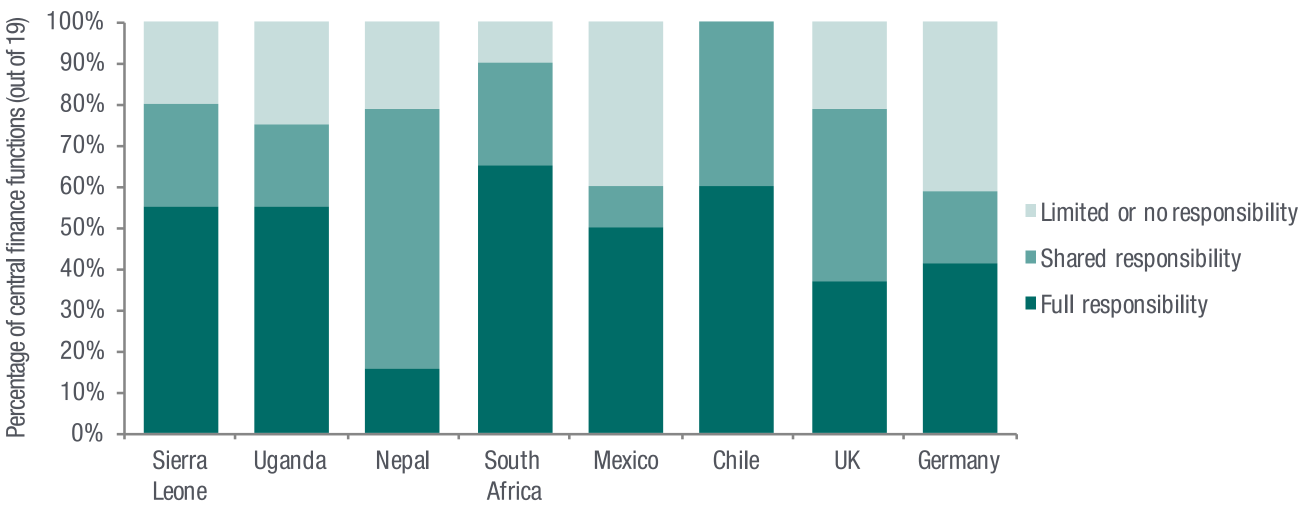
Without understanding how finance ministries function as organisations, they tend to be seen as 'black boxes' – poorly defined entities that mediate between the instruments of public finance and the institutional framework. What are the formal responsibilities of the ministry of finance, and what functions are shared with, or delegated to, other institutions? Fragmented functions are not always a sign of institutional weakness or lack of capability (see figure 2). Indeed, for some functions, prevailing global 'good practice' actively encourages separation of powers or responsibilities. This is often done in the spirit of NPM and has long been followed by finance ministries in Anglo-Saxon OECD countries. Delegation to agencies is often intended to achieve more efficient specialised services, such as the use of semi-autonomous revenue agencies and regulatory bodies for the financial sector. There are also cases where functions are split in order to restrain the powers of the central government.

Attribution of responsibilities and organisational arrangements are clearly related. It is reasonable to assume that a finance ministry that collects revenues directly would have more employees than one that does not, perhaps outsourcing to an autonomous revenue authority instead. These forms of delegation are focused on the delivery function of finance ministries, but the operational core of the ministry of finance – made up mostly of the groups and functions responsible for delivering and regulating the national budget – tends to be much more stable and smaller among the case studies. In many countries this is recognised in the voting structure of the appropriation act – with specific votes for departments that deal with revenues, customs, internal audit, treasury and stores, among others – even if formal reporting lines continue to be to the minister or chief administrator of the finance ministry. However, it also dramatically shrinks the size of some finance ministries.

One important factor is how many staff work in particular functions, their education, training and experience. Furthermore, the characteristics of the (senior) civil servant: do they have tenure? Are they promoted on merit? Are the key technical and managerial positions occupied by people who came up through the civil service or from the outside? To what extent is the civil service open or closed, and does that affect the finance ministry? How is the ministry structured: is it a traditional bureaucracy or a more professional organisation? How are the hierarchies organised, and how do professional staff relate to managers?

Despite differences in organisational arrangements there are remarkable similarities. Whatever the staff size, most ministries adopt a four-tiered bureaucratic structure of directorates, departments, units and sub-units. In practice, there also seems to be a limit on the size of a ministry of finance, at least excluding accountants and auditors cadres. Perhaps this indicates a threshold beyond which there is relatively little to be gained by taking on additional staff or doing so exceeds the tolerable opportunity costs for politicians.

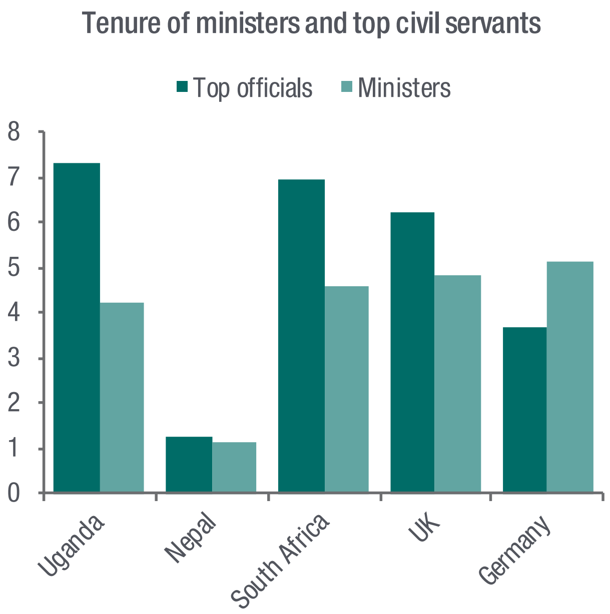
Figure 2: Distribution of central finance functions



Nearly all the ministries studied have found ways to attract and retain essential staff. The larger economies do it predominantly through salaries, while Nepal, Uganda and Sierra Leone use allowances and other benefits (monetary and in-kind) to offer adequate levels of remuneration. This may be a rational reaction to rigid salary and recruitment systems in the civil service more widely, and is supported to some degree by international donors. Unsurprisingly, there are always difficulties in attracting or developing some skills. South Africa's National Treasury must compete with a vibrant financial sector for talented analysts, and has identified upper-middle and lower-upper management skills as particularly challenging to develop internally. In Uganda, the analysis suggests that while it is possible to recruit suitable economists, it is harder to attract those with IT skills.

There is also a strong preference for continuity in leadership and internal promotion (see figure 3). The tenure of recent ministers and top civil servants in most of the ministries studied averages around four years, though some incumbents have exceptional periods in office. The evidence suggests that these ministries rely more prominently on the influence of specific personalities – ministers, top bureaucrats, or even directors – to build the organisation's capability. There is little doubt that such features contribute to more limited institutional capability. So while bureaumetrics are unlikely to be the main drivers of finance ministry capability, they do matter.

Figure 3: Tenure of ministers and top civil servants



3. The evolution of capabilities

Within the broad term of delivery, two functions are worth distinguishing. The central finance function includes a range of administrative delivery functions, where large-scale operational units produce certain products on a regular basis. These are most importantly the administration of tax, customs and other revenues; the administration of cash flows and procurement; and the production of regular reports, audits and other checks on the financial operations of government. Apart from these administrative delivery functions, there is a more complex policy delivery, specifically in the preparation of the budget and related products.

There is a striking difference in the way delivery capability manifests itself in low-income countries (LICs), as opposed to upper-middle-income countries (UMICs) and high-income countries (HICs). For LICs, some aspects of the finance ministry's delivery function pose challenges, whereas in richer countries, delivery is so routine that it seems almost invisible.

As a consequence, many finance ministries tend to start delegating and outsourcing administrative delivery functions. Nearly all of the case-study countries have semi-independent revenue and customs agencies under the ministry of finance, a trend that now extends well beyond the OECD. Germany never had a central tax administration under the finance ministry to begin with, since states and not the federal government collect revenues. Audit and control functions are increasingly delegated to line departments and ministries.

A significant minority of mostly LICs start and conclude budget negotiations much later than the average and submit the budget very shortly before or even after the start of the fiscal year, with negative consequences for its credibility and implementation. Budget crises are not, however, the prerogative of LICs, and especially in the USA a succession of crises, extensions and missed deadlines has almost become the norm. But the ability of the Office of Management and Budget to deliver the budget to the legislature on time is not in question.

The overall trend suggests that administrative delivery capabilities are increasingly outsourced or delegated, and that most ministries of finance have policy delivery capabilities. There seems to be a transition as countries approach UMIC status, at which point these delivery outputs and the capability to run such administrative processes so seldom fail that they are simply assumed to function. There also seems to be a measure of system credibility. As has been observed elsewhere, many weak public financial management (PFM) systems suffer a gap between formal and informal practices, which limits the credibility of the budget and in turn the ability of central ministries to exercise control.

It is reasonable for finance ministries to be reluctant to release control over administrative delivery functions when the credibility of the overall system is in doubt, because it is very closely tied to the flow of funds and therefore the most crucial part of PFM. For ministries at the other end of the spectrum, the distance of administrative delivery from the core policy activities makes these easy functions to delegate.

From analysis to coordination

Finance ministries need to engage in a wide range of analytical activities. The analytical demands broadly fall into four somewhat overlapping categories.

- Aggregate fiscal policy analysis, which is needed to decide the framework of revenues and expenditures, most importantly in the context of budget preparation.
- Specific fiscal policy analysis, which relates to the analysis of particular policy proposals and any short-term issues that may arise during the course of the fiscal year.
- Analysis of departmental spending, both through regular budget negotiations and policy discussions and more tailored reviews of spending requests that reach the ministry of finance.
- Analysis of any other policy or operational question that the finance ministry might take up, which could involve anything from reforms to the accounting system to the rescue of an SOE.

In many LICs, the analytical capability of fiscal policy matters, especially aggregate fiscal policy, is given very high priority. This is understandable for two reasons. Internally, control over aggregate figures underpins many other choices and enables the ministry to control the distribution of resources throughout the government. Externally, international organisations concerned with fiscal sustainability have long invested resources in and paid attention to technical assistance and other forms of support for fiscal analysis capability. From the perspective of a finance ministry in a weak PFM system, developing its fiscal policy analysis capability is a matter of both control and stability in an often-volatile fiscal environment. Outside observers may view this centralising tendency as a source of abuse and long-term instability if the technical objectiveness of the analytical outputs is in doubt.

At the same time, analysis of sectoral policies, very broadly defined, is often weak in LICs. The clearest indicator for the strength of sectoral analysis capabilities is the staff profile in budget departments' sector desks. If the ministry's focus is on achieving and maintaining delivery capability in sectoral spending, then staff often have accounting, legal or administrative training, whereas an emphasis on analytical capability is reflected by employing economists, sector specialists or public policy generalists.

In many HICs and MICs, the tendency is to outsource or share at least some fiscal analysis capability. In part, this is due to the broader international trend of setting up different kinds of fiscal council that take on some form of responsibility for the formulation of aggregate fiscal policy. A related reason is that in countries with very well developed public sources of economic analysis there is less reason to maintain tight control over aggregate fiscal figures because it would be hard to sustain excessive departures from the consensus figures. In Germany, for instance, independent research institutes make macroeconomic forecasts and the government uses the consensus forecast.

Sectoral policy analysis capability, on the other hand, appears as a core function of the finance ministry. Once acquired, this capability is not outsourced or delegated, and investment is maintained even when other functions are shed. In the United Kingdom (UK) the Treasury has been reorganised several times since the mid-1990s, and policy analysis, broadly defined, has become increasingly central to the ministry.

Almost every major function of finance ministries involves coordination. For budget formulation and approval, policy inputs need to be submitted, and positions need to be reconciled and consolidated, so that the resulting draft budget is able to move through the machinery of government. The budget process itself is probably the most consequential and complicated co-ordinative process in government – at least in countries where the budget is a credible indicator of future public spending and government intent. This sets finance ministries apart from many other parts of government, even central government, where core functions can be performed in relative separation.

In LICs, there is often a mismatch between analytical capability and the legal mandate to enforce policy decisions; and the capability to coordinate the performance of central finance functions. In the literature, this has often been cast as the distinction between formal and informal practices, where the latter do not match what the former appear to promise. This divide is of particular concern in countries where the informal budget process is deliberately used to facilitate illicit practices. In several of the case-study countries, however, most public organisations seem to aspire to follow the formal rules of government, but are hampered by the lack of coordinative capability.

Regulatory capability does not refer only to the policy regulation of particular sectors, such as banking and financial sector regulation. For finance ministries it also includes the ability to shape the financial behaviour of other parts of government. This has traditionally been done by command and control, i.e. hierarchical oversight of financial operations, sometimes of one transaction at a time. In such contexts finance ministries do this by supplying a steady flow of financial transaction outputs – approvals, cheques and tenders. When these delivery capabilities are outsourced or delegated, the function of the finance ministry shifts towards regulation. This shift significantly changes the demands on the ministry, as controls disappear and staff are expected to define the operational framework rather than being involved in the details.

The biggest impact on finance ministries of a shift towards regulation is on the number of employees. Existing regulatory agencies as well as more policy-oriented regulatory units employ fewer but more senior staff, as the direct processing of transactions gives way to the setting of guidelines and frameworks. This reduces the number of lower-ranking staff who used to process transactions. At the same time, concerns about a possible identity crisis that might overwhelm budget offices as they let go of detailed control and shift towards policy and regulation seems to be unfounded.

There is a clear difference between LICs on the one hand, and MICs and HICs on the other. Finance ministries in LICs focus more on transactions and control, while those in higher-income countries emphasise policy functions, regulation and coordination. This is broadly consistent with a general OECD-wide trend towards NPM and delegation. The reasons for these changes are complex, reflecting both changing budgeting fashions as well as evolving challenges as countries develop, but also an evolution of capability. For whatever reason, some finance ministries reach a stage where the transactional focus of many delivery functions assumes less importance for the leadership of the ministry, which precipitates a shift towards increasingly policy-oriented analytical, coordinative and regulatory functions.

There is no necessary transition from a control to a policy focus, however. In Western Europe alone, the institutionalisation of policy advice at the centre of government has taken quite different forms. The case studies suggest that finance ministries pay uneven attention to coordination and policy-oriented analysis, and often pay a price for a lack of coordination and for an inability to engage in policy discussion. Especially in aid-dependent countries, much of the policy analysis function is effectively outsourced to international organisations. There does not seem to be any inherent reason for LICs to prevent finance ministries from doing this and investing more in their policy analysis and coordinative capabilities.

What do capabilities mean for policy?

There are no simple lessons for how best to strengthen the capabilities of finance ministries. The findings from the broader literature on institutions, fiscal or otherwise, are highly relevant here. The external environment enables and constrains finance ministries in many different ways. The size and composition of the public sector, as well as the level of economic development, among many other factors, shape the challenges facing the ministry, with important implications for how it engages with the rest of the government. Institutional arrangements, such as the political and electoral system, the balance between the legislature and the executive, and the administrative legacy – create the space in which the ministry operates. This space might be extraordinarily broad and allow a large amount of discretion to the minister and the ministry, as is the case in Chile and the UK. But more often there is a range of constraints that need to be addressed before making any changes to the way the finance ministry operates.

Although it is a truism in international policy discussions, political leadership matters for capability. Most finance ministries see themselves as critical advisers to politicians. The work of the ministry ultimately determines how far any government's political agenda is funded and implemented. Many finance officials point to their ministers as providers of political cover, which enables them to do their work – whether this entails the largely transactional delivery of administrative functions or the provision of policy-driven analysis and coordination. If this political protection fails or the relationship becomes more antagonistic, problems appear quickly and noticeably.

One particularly important factor is the stable tenure of ministers and senior officials. Many finance ministries, at very different income levels, with sustained capability did so under very stable terms in office of both the political leaders and their senior civil servants. In the absence of stable political leadership a consistent senior management group can still provide stability for the organisation to perform and evolve. If the senior management also experiences rapid turnover, capabilities seem to suffer over the long term.

Given a certain degree of institutional space, matters such as organisational structures, pay and other civil service details affect the performance of finance ministries. These issues remain poorly researched. There is very little comparative information on organisational structures, civil service pay, promotions and incentives, and ways in which finance ministries perform their functions to which officials or advisers could turn. In short, finance ministries, especially in LICs, are poorly served by the lack of research and evidence on which to draw. Public administration and organisational research have examined such issues in great detail, and the international PFM community could readily tap into the available research and apply it to ministries of finance.

The findings from this report and from the nascent literature on finance ministries could form the basis of a practical approach to strengthening the capabilities of finance ministries.

Two immediate changes appear particularly worth exploring:

First, a reform agenda, whether it is part of a broader PFM reform plan or specifically tailored towards the finance ministry, should not be narrowly focused on PFM but should draw upon public management research, as well as the broader evidence on government institutions. This might start to fill the ‘missing middle‘ in the current analytical toolkit.

Second, the analyses presented in this report could provide the basis of a capability bottlenecks assessment. A combination of (1) fiscal institutions, (2) central finance functions, (3) organisational structures, and (4) tenure and civil service features could be used to identify the most critical constraints on the ability of a ministry to perform its specific tasks.

There is still the need for a dose of realism because the evidence suggests that finance ministries cannot wholly escape the institutional environment that sustains and constrains them. Nonetheless, they could still position themselves better to make the most of this institutional context.

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