



The ministry of finance 'challenge function'

A public financial management introductory guide

Sierd Hadley and Bryn Welham

Abstract

This public financial management introductory guide discusses the ministry of finance 'challenge function'. The challenge function describes how the finance ministry investigates and scrutinises the policy and expenditure choices of other public entities. In OECD countries the challenge function usually puts a greater emphasis the high-level policy choices of spending agencies. By contrast, in many developing countries the focus is more on basic expenditure control, meaning that the finance ministry challenge function tends to look at detailed spending decisions and compliance with budgeting rules. This document summarises some of the literature on the nature of the challenge function, how it works in different countries, and options for reform.

Overseas Development Institute

203 Blackfriars Road
London SE1 8NJ

Tel. +44 (0) 20 7922 0300
Fax. +44 (0) 20 7922 0399
E-mail: info@odi.org.uk

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Public financial management introductory guide

This 'The Ministry of Finance challenge function' paper forms part of a series of introductory guides on key topics in public financial management (PFM). They are written specifically for capacity-constrained environments and provide an overview and discussion of the main issues related to each key topic, highlighting useful literature. Each introductory guide includes practical suggestions on how capacity-constrained governments can approach reforms, together with brief outlines of other countries' experiences of PFM reform. They are not intended to be detailed guides to the design and implementation of reforms. They are based on a review of the relevant literature and the practical experience of ODI staff working in these areas.

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1. Overview of the challenge function

1.1 Introducing the challenge function

Finance ministries are commonly expected to operate a ‘challenge function’ when delivering their institutional mandate. Indeed, policy advice on public sector budgeting often assumes the existence of such a role alongside the view that an effective ‘challenge function’ will lead to better public financial management (PFM) outcomes across a range of areas (e.g. CABRI, 2006; Schick, 2001). However, the different types of the expected challenge function are not well defined or documented in the literature on PFM, and the ways that they can be developed in different contexts are often unclear. This note draws on both the available literature and the experience of delivering technical assistance to budget reform to strengthen the challenge function in the area of budget and expenditure management.

The note will respond to five key issues:

- The nature of the challenge function and its importance in relation to public sector budgeting and expenditure management.
- How this kind of challenge function is organised in different countries.
- The broader contextual factors which influence this challenge function.
- What capabilities and tools a finance ministry could use to support a challenge function of this kind.
- Issues to consider when approaching the application of challenge function reforms.

In common with the other introductory guides in this series, the discussion is for those working in low-income and low-capability states (often called ‘fragile states’), where the need for basic but workable reform options to improve the functioning of PFM systems is greatest. It also addresses primarily the challenge function of the finance

ministry,¹ as opposed to challenge functions exercised by other public institutions such as the legislature or head of government, while acknowledging that these other bodies may be important players in the wider PFM system (see Box 1 below).

1.2 What is a ‘challenge function’ and why is it important?

1.2.1 The finance ministry challenge function

Finance ministries have a wide range of responsibilities. For example, Allen and Krause (2013) and Krause et al. (2016) identify around 20 functions that are common to central finance agencies. These range from macroeconomic and fiscal management, through to the details of financial reporting and accounting policy. In many of these areas, the finance ministry will be the lead institution for delivering the function; in others it may delegate to, and/or follow the lead of, other institutions. In all these areas, however, successful delivery of the finance ministry’s mandate will require some degree of involvement, understanding and cooperation from other institutions. The ability of the finance ministry to secure these inputs means building an institutional relationship, which will inevitably at some point have areas of disagreement, tension or lack of understanding between parties. The finance ministry ‘challenge function’ is therefore inevitably a key part of the relationship between finance ministries and other institutions.

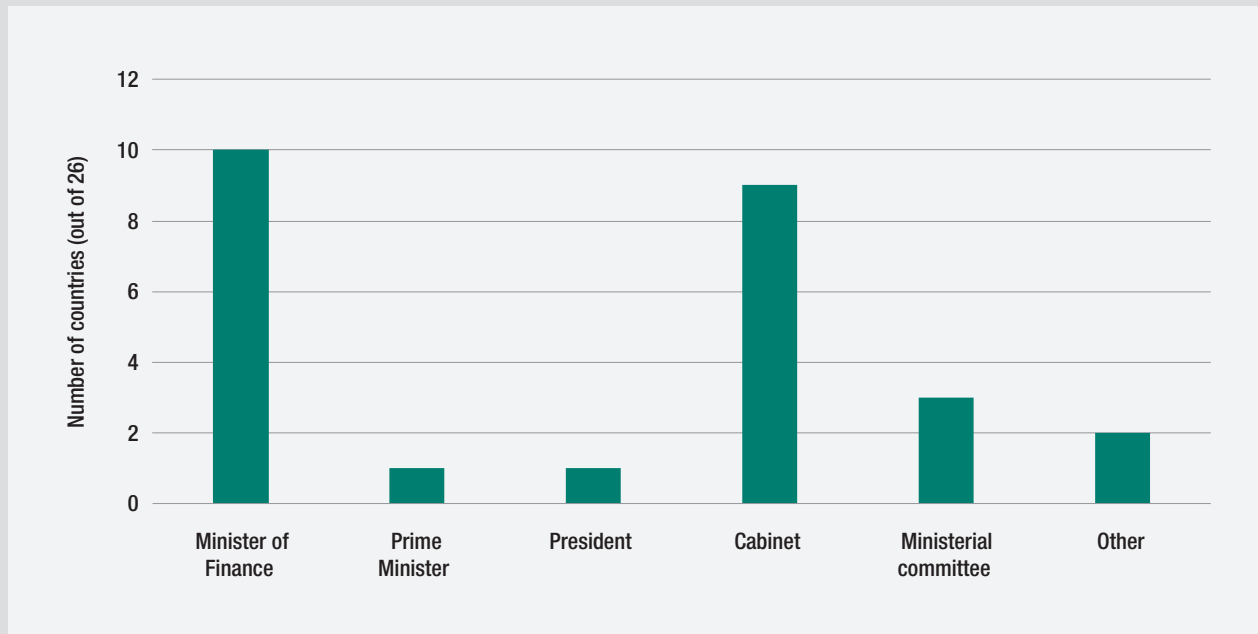
In this discussion, the challenge function will be thought of as the investigation and scrutiny of the spending, expenditure management processes and policy choices of line ministries, departments and agencies. Where these do not align with the objectives of the finance ministry, an effective challenge function typically means the finance

1. The term ‘ministry of finance’ is used to describe the central finance agency that has a responsibility for public economic and financial management across the government and therefore has some form of ‘challenge’ relationship with all other government bodies. This ‘central finance agency’ is usually the ministry of finance, but this is not always the case. For example, some countries may have a separate ministry of budget with expenditure management responsibility, or ministry of planning with responsibility for long-term economic development and public investment management. However, for ease of expression this note will refer to the ‘finance ministry’ to mean the central finance agency exercising the challenge function under discussion.

Box 1: Other central institutions that exercise a challenge function

There are usually other public sector institutions that have a mandated ‘challenge function’ regarding fiscal, expenditure and financial policy alongside the finance ministry. Within the executive, there may be challenge roles for the cabinet, special ministerial committees, the office of the president or prime minister, or other central agencies like a planning ministry.

Figure 1: Who resolves budget disagreements in African countries?



Source: 2008 CABRI Budget Survey (question 26)

There are also bodies with a challenge mandate that are external to the executive arm of government. Notably, legislatures have a well-established role in holding government to account, ultimately by withholding approval for its’ expenditure plans. This legislative oversight is often supported by parliamentary budget offices and independent audit offices who report publicly on the handling and use of funds by the executive. Independent ‘fiscal councils’ (IMF, 2013) are increasingly used by governments to monitor and influence their fiscal policy through some form of external ‘challenge’ role. Further removed still are political parties and institutions related to the media and civil society, which are increasingly viewed as integral to good financial governance (Andrews, 2007; Hood and Heald, 2006).

Practitioners working on developing the challenge function in the finance ministry should aim to situate their work within this broader context – asking who else is challenging tax and spending and other policy decisions, and how effectively are they exercising this role.

ministry asking, requiring or persuading line ministries to do something different to what they might otherwise have done. Such a relationship is necessary if a finance ministry is to deliver its many functions and achieve its economic, spending and policy goals.

1.2.2 The challenge function in relation to expenditure and budget management

The focus of this discussion will be the challenge function of the finance ministry in relation to its budget and expenditure management responsibilities. This particular focus was chosen in part because a discussion of the nature and operation of the challenge function across all areas of finance ministry responsibility would be too broad for one

paper to cover. In addition, a focus on budget preparation and execution is useful given the centrality of this process to the finance ministry’s operations. The process of budget preparation and expenditure management also touches on a number of other areas of core finance ministry responsibility (e.g. macro-fiscal forecasting; fiscal risk analysis; treasury and cash management; internal control) making it a useful starting point from which to consider the idea of a challenge function.

Most notably, the budget and expenditure management challenge function of a finance ministry plays a key role in solving the perennial ‘common pool’ problem that is especially evident in the preparation and execution of the national budget (von Hagen, 2005). All line ministries

have incentives to maximise their allocation, even if in the aggregate this would result in an unsustainable level of public spending, inefficient allocation of resources between sectors, and/or low efficiency of spending. The finance ministry is the ‘resolver’ of this problem through setting and controlling ministerial allocations, trading-off claims and managing overall expenditure in line with collective government plans and priorities. The challenge function is a key part of how finance ministries do this (Wilhelm and Krause, 2008; ODI, 2005; Lawson et al., 2005).

1.2.3 Types of challenge function

There is a range of different ‘challenge’ roles that the finance ministry can play in budget and expenditure management. These roles are not explicitly set out in the literature, but a review of key sources suggests the challenge function can be usefully grouped into two types:

- *Compliance challenge function.* The enforcement of PFM rules governing budget preparation, execution, accounting and reporting. It relies on establishing and communicating clear regulations, flows of information and fostering a compliance culture and ensuring credibility of enforcement mechanisms, which may be particularly difficult in fragile states (Schick, 2007; Diamond, 2013a).
- *Policy challenge function.* The use of financial and non-financial information to assess spending and other policy decisions made by line ministries – beyond immediate matters of expenditure compliance and control – with the aim of aligning these with wider government and/or sector objectives (Wilhelm and Krause, 2008; Robinson, 2013).

The distinction between the two types of challenge function is not always clear cut and it is likely that a finance ministry will engage with line ministries on both types of challenge simultaneously. In the consideration of a spending request by a line ministry, for example, the challenge may focus on whether it was submitted at the correct part of the budget cycle and if spending can be effectively controlled during execution (compliance challenge), but also if the proposal is overall affordable and whether it supports broader policy goals (policy challenge).

How the challenge function is conducted will also depend on the expenditure management objective it aims to fulfil, whether that is aggregate fiscal control, allocative efficiency or operational efficiency (CABRI, 2006). An effective policy challenge function for aggregate fiscal control is likely to consider spending requests and/or changes in line ministry policy approaches with reference to the future impact on total spending or debt. In contrast, a policy challenge function targeting allocative efficiency will use data and analysis to consider issues of resource distribution and effectiveness, such as the value for money of particular policy decisions, the equity of resource

allocations across priorities, and/or the degree to which the policy decisions of ministries support the finance ministry’s broader economic and financial policy objectives.

1.2.4 The changing nature of the challenge function across income levels

As income levels and capability rise there tends to be a transition from a challenge function that largely focuses on transactions and process compliance towards a focus on issues of policy (Krause et al., 2016). In many OECD countries, like the UK, large parts of the mid- and upper-level bureaucracy are mostly involved in policy work (Welham, 2016). In developing countries, however, resources in finance ministries are typically dedicated to transactional work, such as the processing of virements. Indeed, some policy functions in the poorest countries – such as detailed expenditure analysis or medium-term analysis of fiscal policy – are *de facto* outsourced to international organisations in the absence of sufficient government capability.

A key part of the transition from low-income to middle-income public finance systems is establishing controls over daily delivery tasks, such as issuing payments, paying salaries, commitment controls and procuring goods and services. Without this control it is hard to maintain basic fiscal discipline and macroeconomic stability. As a result, no discussion of the challenge function can be completely divorced from efforts to establish or maintain basic internal controls. However, establishing basic compliance and controls is not the primary focus of this introductory guide.

Instead, this discussion is aimed at donors and governments considering options for strengthening the *policy challenge* function in developing countries for both affordability and allocative/operational efficiency. These are typically the areas that would be referred to under recommendations by technical assistance to ‘strengthen the challenge function’. This challenge function is generally the focus of line ministries, but it has many parallels with the challenge function required to manage revenue forecasts and targets, as well as with the management of state-owned enterprises.

1.2.5 Finance ministry ‘capability’ in supporting the challenge function

A full discussion of the nature of institutional effectiveness is beyond the scope of this paper, but broadly speaking *capacity* can be taken to mean the particular endowment of the finance ministry in terms of the numbers and quality of its staff (i.e. their skills and experience) and the effectiveness and complexity of its tools (e.g. IT systems, financial monitoring systems). *Capability* then refers to how this ‘raw’ capacity is organised and how it interacts with the formal and informal political, bureaucratic and institutional context to create (or not) the ability to deliver the actual functional effectiveness of an institution (Andrews et al., 2012; Tilley et al., 2015).

It is clear, for example, that a strong finance ministry can draw on a range of sources of authority and influence to deliver an effective challenge function. Some of this authority is ‘formal’ in that various laws, regulations and/or administrative systems allow the finance ministry to require certain behaviours from others – although in low-capacity and low-income environments compliance may be more limited. Beyond formal rules, the finance ministry typically has a number of sources of informal authority and power that can also help support its challenge function (Krause et al., 2016; Allen et al., 2015). Such informal powers may stem from its ability to withhold or reallocate funds, access donors and recruit better staff and/or from the political authority of the finance minister, who is often a ‘special’ member of the cabinet with particular political status.

To think about how these various sources of authority can be harnessed to support a challenge function, they can be thought of as supporting (or undermining) a number of core capabilities of the finance ministry (Krause et al., 2016):

- There is a strong *regulatory* component to the challenge function. Most would agree that the challenge function manifests in the ability to say ‘no’ to spending requests – or at least the ability to influence how a spending proposal is structured, how generous or expensive it is and how it is delivered, before granting approval. This power has many sources. The finance ministry may have the power to withhold resources during budget execution or the appointment of accounting officers. Finance ministers are usually politically significant individuals who can hold a particularly elevated status in government. This informal political standing can enhance the credibility of saying ‘no’ to spending requests or to demand time to feed into policy discussions.
- *Analytical* capability is central to the policy challenge function. Key to saying ‘no’ or ‘yes’ in a way that is credible is the ability to understand what the consequences of that decision will be. For this, the ability to understand and manipulate financial and non-financial performance information is essential. Finance ministries are often able to attract some of the brightest and most motivated civil servants. This can give it an advantage regarding the ability to analyse information, ask the right questions and judge the quality of the response, ultimately allowing the finance ministry to attempt to influence line ministries. Having an overall picture of the public finances also gives the finance minister a special negotiating power when managing politicians in other departments or in cabinet.
- There is also a strong *coordinative* side to an effective challenge function. This coordination builds links between the bureaucracy and politicians (vertical coordination) and between the finance ministry

and other government agencies, including spending ministries (horizontal coordination). Vertical coordination ensures that policy advice and political decisions flow reliably between politicians and bureaucrats, and so develop the finance ministry’s overall policy position. Horizontal coordination is necessary to gather and communicate key information on spending plans and expenditure policies in a situation where information is often asymmetric between the finance ministry and other government agencies. While finance ministries may be able to access detailed information on line ministries’ expenditures through a computerised financial management system, information relating to specific sector policy impacts and choices is often known to line ministries and not to the finance ministry. In contrast, information on *overall* government spending and certain cross-cutting issues is more likely to be asymmetric in favour of the finance ministry. Strong finance ministries are well placed to use this position to bring together relevant parties in policy discussions, often as part of the budget process.

The exercise of the challenge function by a finance ministry is, therefore, not simply a case of a well-staffed ministry engaging in ‘demand and conquer’. Instead, a finance ministry needs a range of capabilities to deliver an effective challenge function. Those may differ between a compliance and a policy challenge when in pursuit of different expenditure management objectives. For example, access to and the ability to analyse non-financial information is a fundamental feature of a policy-based challenge function, which may not always be true of a compliance challenge. Key to developing the challenge function in any context will, therefore, be identifying and supporting the relevant capabilities to analyse, regulate and coordinate the various political and technical pressures that shape spending decisions in that context.

1.3 The broader context of the ‘challenge function’

Capabilities underpinning the challenge function will be constrained (or enabled) by the external environment. As with all institutions, there is a high degree of ‘path dependency’ where systems have evolved over time to fit a certain environment, and will continue to do even if the environment itself begins to change. In other words, the way the challenge function works in practice depends to a large extent on the existing economic, political and institutional context of a country. Understanding this broader context is necessary in order to judge what might be possible in terms of developing a strong challenge function. The following discussion highlights some of the many relevant factors that affect the nature of the finance ministry challenge function, particularly in low-income and low-capacity environments.

1.3.1 The macroeconomic context

One significant contextual factor which the finance ministry must respond to is the fiscal and macroeconomic situation in a country. Historical accounts suggest that the development of a policy challenge function in most OECD countries coincided with rapid increases in the size and complexity of public spending – typically as governments moved away from financing wars towards social spending programmes (Krause, 2013). Though the same path may not be followed in low-income countries, the nature of the challenge function will almost certainly be tied to broader fiscal and economic changes.

There are also macroeconomic factors that will likely affect how easy it is to deliver an effective policy challenge function in low-income countries. For example, the IMF (2011) finds that the probability, size and cost of economic shocks is higher in low-income countries than in the rest of the world. This may weaken the analytical capabilities of the ministry and require stronger coordination to respond to changes in the fiscal position. Other research suggests that reallocating expenditure (a proxy measure of an effective challenge function) is easier in periods of expenditure growth, and harder in periods of spending restraint (Krause, 2015). The literature does not provide strong conclusions, but intuitively it might be easier to deliver a challenge function for allocative or operational efficiency in times of steady macroeconomic expansion and increases in expenditure.

1.3.2 The political and institutional context

There is good evidence from OECD countries that political institutions shape the effectiveness of the finance ministry in controlling aggregate revenues and expenditures, and by extension its challenge function (Hallerberg et al., 2009; Wehner, 2010). For example, there is usually a one-for-one trade-off between the power of the legislature and the power of the executive, over budget allocations. The weaker the executive, the less likely it is that the budget will match the finance ministry's spending priorities, and vice versa. That is partly why countries with a weak legislature tend to find it easier to control spending (von Hagen, 2005). Other factors that have been shown to affect fiscal outcomes include the party composition of the government and the existence of competitive elections. This finds that, generally, countries with smaller coalitions or one-party governments and regular, fair elections are more likely to support fiscal discipline.

These institutional dimensions have also been shown to affect fiscal management in low-income countries and fragile states, though research is more limited (e.g. Dabla-Norris et al., 2010). However, the rules of the game for public administration are different in most advanced economies. Public administration is likely to be based on personalised deal-making rather than an impersonal application of the law (Levy, 2014). For example, in countries like Afghanistan or Malawi, key aspects of

financial management, and therefore the strength of the challenge function, is determined mainly by informal institutions rather than formal ones (Hogg et al., 2013; Rakner et al., 2004).

Developing a challenge function in a more informal environment is likely to require more than just the application of new rules. It also places greater emphasis on understanding the government's 'revealed preferences' (i.e. actual behaviour) as opposed to strictly following public budget policy and published strategic planning documents, which may not accurately reflect government's intentions. Without this anchor, technical officials may lack the 'political cover' to challenge spending requests. Ultimately, efforts to build a challenge function in the short run will require more extensive use of personal links between key players in the expenditure management process. Over the medium term some of these interactions may be gradually institutionalised (formally or informally).

Box 2: The challenge function and political and institutional change in Uganda and South Africa

Case study evidence suggests that the evolution of the challenge function is closely related to broader political and institutional shifts. If the ability to reallocate spending is a good indicator of an effective challenge function, Uganda and South Africa provide instructive experiences for low- and middle-income countries.

In Uganda, the power of the finance ministry to use its challenge function to control expenditures emerged alongside broader political shifts. In the early 1990s, in response to poor fiscal decisions that triggered hyper-inflation, President Museveni altered the institutional framework of spending control to significantly increase the challenge function of the finance ministry. He consolidated the finance and planning ministries and delegated substantial authority to the new finance ministry to keep spending under control (Whitworth and Williamson, 2010; Simson and Wabwire, 2016). This contributed to the restoration of spending control and broader macroeconomic stability.

In post-Apartheid South Africa, the separate ministries responsible for finance were merged into the National Treasury, and the new organisation built a budget process with an explicit policy focus. This recognised the 'new era' of South African politics and the need to urgently and fundamentally review and amend spending policies across the board in light of the country's new political leadership. The number of staff on budget desks was increased five times over the next ten years so that the Treasury could drive policy discussions in key areas and maintain fiscal stability, while under huge pressures to increase public spending (Krause and Mustapha, 2016).

1.3.3 The organisational context

Organisational issues will also affect the operation of a challenge function. One general picture is that the functions of a central finance agency are often fragmented between multiple ministries and agencies in low-income countries (Allen and Krause, 2013). In some contexts, the need for politicians to accommodate a broad political coalition might mean creating numerous ministerial positions and supporting institutions (e.g. countries that have some combination of a ‘Ministry of Finance’, a ‘Ministry of Budget’, a ‘Department of Treasury’, a ‘Ministry of Economic Planning’ etc.). Fragmentation can lead to confusion and a lack of clarity over roles, responsibilities and mandates which undermines the coordinative capabilities of the finance ministry and could in turn make delivery of a coherent challenge function more difficult. One such example is the separation of finance and economics ministries. It could be reasonable to expect finance ministries to direct their challenge function mainly at maintaining financial control (e.g. Germany, Swaziland), while combined finance and economics ministries have a broader mandate in actively trying to steer macroeconomic and spending policy (e.g. UK, Uganda).²

Another useful distinction is between the macro- and micro-controls of budgeting (Krause, 2009). Budgets may be managed through micro-controls of individual inputs and line items, such as specific control as to whether to hire permanent or contract staff, or through macro-controls, based on managing larger policy frameworks that are linked to the aggregate fiscal position and high-level policy rather than detailed spending decisions. Countries that rely on micro-controls may find it more difficult to develop an effective policy challenge function for allocative and operational efficiency, since exercising controls over specific spending decisions will require a different skill set to exercising control over high-level spending aggregates. However, there are exceptions, such as Chile, where micro-controls have been maintained alongside the capabilities to improve the efficiency of resource allocations (Krause, 2015).

Finally, there appear to be shifts in organisational structures as finance ministries become more advanced and engaged in policy. Mintzberg (1979) developed an influential theory with five ‘ideal types’ of organisation (see also Lunenburg, 2012, or Krause et al., 2016). Applying this theory can help distinguish how policy is coordinated (e.g. through personal communication or a formal bureaucratic

process) and who delivers the policy analysis (e.g. top management or lower-level technical staff). This can improve understanding of who will be exercising the challenge function and what they need to deliver it more effectively. More personalised systems will require different support than if the challenge function is institutionalised throughout the cadres of policy staff. Box 3 gives a longer explanation.

1.3.4 Human resources

The policy challenge in particular relies on the ability to analyse information. Low levels and availability of financial and human resources are likely to be a binding constraint on this capability in low-income and fragile states, and so on the strength of the challenge function (Krause et al., 2016). The units responsible for managing line ministry policies and budgets in the UK and Kiribati provide extreme examples. In the UK, where the Treasury is well resourced and skills are generally available, a policy officer may oversee one part of one welfare system. In contrast, the finance ministry in Kiribati is much smaller and thinly spread: a policy officer of the same level may typically oversees the budgets of several ministries. There are also considerable challenges finding specialised skills to manage projects. This makes delivering an effective policy challenge difficult, if not impossible. Overall, countries with more generously funded finance ministries and a deeper labour market on which to draw are therefore more likely to be able to operate a strong challenge function.

A case study of this is provided by Kuteesa et al. (2010) in the context of Uganda’s budget and planning reforms in the 1990s. One notable change was the consolidation of the finance and planning ministries, and the responsibilities for budget policy and expenditure management within one department – the budget department. This made the most of a relatively small pool of staff in the public sector with the necessary skills, who were then maintained in the same post for relatively long periods to build up the necessary competencies and technical skills to manage policy and expenditure issues. Unlike typical accounts of reform, which focus on tools and processes, this reveals the importance of human resources and competencies to delivering an effective challenge function.

1.3.5 PFM systems

Unsurprisingly, the nature and effectiveness of basic PFM systems will also affect the strength of the challenge function. Without functional PFM systems, it will be more difficult for a finance ministry to build up an

2. Note that some argue that the challenge function of a combined finance and economics ministry may become overly focused on shorter-term fiscal policy rather than longer-term development objectives. For example, there has been a lively debate in the UK in recent years over the balance of fiscal and economic mandates in the UK Treasury (e.g. *Prospect Magazine*, 2016; Kerslake, 2016).

Box 3: Mintzberg's typology of organisations

There are many different ways to analyse the structure of organisations. One influential typology identifies some ideal types of organisational structure (Mintzberg, 1979). Three of those are particularly useful for this analysis: the simple structure, the machine bureaucracy and the professional bureaucracy.

The first ideal type is the 'simple structure', where few support units and other back-office functions exist. Coordination typically occurs in the form of direct supervision between senior managers and staff, with little differentiation and specialisation. The key part of the organisation is the top management, where important decisions are centralised. The organisation is usually so simple that a single person, or group of people, can stay in more or less direct charge of the day-to-day operations of the organisation. In public finance, this is the stereotypical finance ministry in a very small or very poor country.

The second ideal type is the 'machine bureaucracy', which resembles the classic image of a sophisticated, and cumbersome, bureaucracy. Work is delivered mainly by large and specialised units, driven by detailed formal procedures and rules. Coordination takes place by standardisation of processes, and the middle layer of the organisation is the key part of the organisation. All the different possible compliance and oversight functions are very well developed and located within the organisational structure. Staff in the operating core have little discretion over how to approach their work, and they follow the rules and standards laid out for them. Top managers are quite far removed from the operational activities of the rank and file. In many ways this is the typical image of any traditional government ministry, especially in continental European countries.

The third type is the 'professional bureaucracy', which relies not on the standardisation of procedures but on highly developed skills. The operational work is carried out by specialists who are given considerable discretion in how they pursue their goals and objectives. It is therefore a much leaner and flatter organisation, where the operating core emerges as key. The middle layer of the organisation is smaller and simpler, as fewer support units are held in-house and fewer compliance and supervision mechanisms are needed. In principle, this is the image of a finance ministry after having gone through New Public Management reforms, where routine tasks and functions are outsourced or delegated and the ministry is left to focus on its macro-budgetary and policy roles.

Table 1: Mintzberg's typology of organisations

Type	Coordinating mechanism	Key part of the organisation	Decentralisation of decision-making
1. Simple structure	Direct supervision	Senior managers	Centralised
2. Machine bureaucracy	Standardisation of work processes	Middle managers and support units	Limited horizontal
3. Professional bureaucracy	Standardisation of skills	Operational staff	Vertical and horizontal

Source: Extracted from Krause et al. (2016)

effective policy challenge function, especially the necessary regulatory and analytical capabilities, because of the lack of basic controls and the poor availability of financial and non-financial information. Diamond (2013a) considers the weaknesses in PFM systems in low-income countries that are likely to affect the policy process, and by extension the challenge function as well, including the following:

- *Incomplete coverage of the budget.* This means that policymakers may not have a full view of the spending trade-offs that must be made.
- *Budget systems are often geared towards control (e.g. micro-control over line items), not policy.* More specifically, the chart of accounts and other classification systems focus on budget inputs rather than outputs and in doing so support effective micro-budget controls but not necessarily policy analysis.
- *Lack of reporting on policy implementation.* Generally, even financial reports take a long time to be prepared and are often inaccurate. Non-financial performance data takes even longer to gather, if it exists at all.
- *Budget execution does not closely follow budget appropriations.* This reduces the incentive for line ministries to engage in the budget preparation process, but it may increase the importance of the challenge function during budget execution instead.

Where these problems are very pronounced, they will make delivering a policy challenge function more difficult, and may serve to lower the level of ambition as to what challenge functions can deliver. Over time, if finance ministries are able to improve their basic PFM systems, their capacity to operate an effective challenge function will likely improve as well.

1.3.6 Applying these ideas to the challenge function

A good understanding of the kind of political and economic context issues noted above in a low-income and low-capacity environment will likely result in a series of limitations and constraints to what is feasible. To summarise some of the discussion so far, key areas for consideration when deciding if and how to apply reforms to strengthen the challenge function include the following:

- Do domestic politics result in demand for *overall fiscal discipline* and the *delivery of key outputs*? If there is little domestic political demand for sound fiscal policy and effective delivery of government functions, attempts to build an effective challenge function will be more difficult. It may be more appropriate to focus on strengthening the external ‘checks’ on fiscal discipline (such as the need to stay compliant with an IMF programme), building political commitment for service delivery, or aligning with donors to support policy priorities.
- Is public administration *rules-based* and operating according to technocratic processes and procedures or *personalised* and operating according to the personal relationships between senior officials and ministers? In a highly personalised environment, building a challenge function will require greater attention to building or influencing the informal processes of fiscal management and the key personalities that govern them. In a rules-based environment, strengthening formal/legal processes for engaging with line ministries may be more successful.
- Does the finance ministry have *sufficient authority* to play a challenge role and how does this relate to other institutions in the country? If the challenge function of the central finance agency are shared between more than one institution (e.g. shared with the legislature in the USA, or the Bureau of Budget in Liberia), officials will need to consider what role they can realistically play. If it does have substantial authority over the budget (e.g. UK, Chile), then it will make the challenge function easier to direct.
- Is the budget managed through *macro- or micro-controls*? Finance ministries that exert micro-controls over expenditure on a line item basis need to dedicate significant resource to these day-to-day activities. This reduces the resources available to develop a higher-level policy challenge function. Choices might have to be made about what level of delegation can be given to ministries in order to free up finance ministry resource.
- Which staff have the *capacity and political cover* to exercise a technical challenge function in the finance ministry? To challenge line ministries requires a high degree of human capacity and the political authority to turn this into the capability to say ‘no’ to line ministries. In many countries this capacity and capability is concentrated at the top of the civil service (e.g. Sierra Leone), which limits the scope and depth of the challenge function that can be delivered. In others, where these

skills are widely available and authority delegated, the challenge function can cover issues in greater depth (e.g. Uganda, South Africa).

- What kinds of *information* are available to support a challenge function and are these adequate? The type of information needed to monitor compliance (e.g. rate of spending across line items, speed and accuracy of accounts reconciliation) will be quite different to that needed to deliver a policy challenge (e.g. unit cost of service delivery, benchmarking of costs to international comparators). If PFM systems are unable to deliver basic financial and non-financial information, then greater efforts may be needed to develop this capacity first (or concurrently), or to develop alternative sources of data.

1.4 How is the challenge function organised in different countries?

Despite these contextual differences, certain budget and finance arrangements are relatively common. Looking at specific country examples, it is possible to group them into systems that facilitate the engagement with line ministries directly, and those that aim to control the internal incentives of the finance ministry itself.

1.4.1 Engaging with line ministries

Common organisational features of the challenge function *that face outward towards a line ministry* include the following:

- Institutions convened for specific budget events, often as part of budget preparation. These provide a focused point of ‘challenge’ to line ministry plans. They include *budget hearings* as part of budget preparation, where line ministries come to discuss (and defend) their spending plan; *budget planning committees* convened by the finance ministry to oversee the budget preparation process and ultimately to make high-level trade-offs across governments; *sector working groups*, which involve a broader set of government and donor stakeholders that agree and plan expenditure for an entire sector; and *‘ministerial committees’*, which are usually convened on a more *ad hoc* basis to challenge specific institutions over specific spending. In some cases these involve other central agencies, such as officials from ministries of planning, public service or the president/prime minister’s office.
- Units/teams designed to coordinate expenditure management with line ministries on an ongoing basis. Finance ministries usually have permanent *spending teams* or *budget desk officers* whose role it is to monitor the financial activity of a particular line ministry, a group of ministries or sometimes a specific category of expenditure, such as capital spending or the payroll. This can be organised in a number of different ways. For example, in the UK the relationships with line

ministries on process compliance and policy challenge functions are combined in a single ‘spending team’. In contrast, in Germany, policy challenge and expenditure control functions are split between different finance ministry units. Some countries hire policy experts in the subject relevant to a particular ministry’s activities (e.g. South Africa, where the National Treasury uses health professionals to oversee the health ministry) whereas others rely on career civil servant policy generalists (e.g. the UK). Some finance ministries deploy their own staff to the finance and budgeting section of major line ministries as a means of control and oversight (e.g. in Sierra Leone) while other countries maintain clear separation between the spheres of authority of finance ministries and line ministries.

No country will operate the full range of organisational arrangements listed here. Instead, the wide variety of approaches reflects the very big differences in local context described earlier. However, one common finding from research is that for these arrangements to provide an effective challenge function for expenditure management they need to be closely linked with the budget process (Wilhelm and Krause, 2008; ODI, 2005).

1.4.2 Linking technical advice to politics

Advanced countries invest more heavily in the roles, teams and institutions that link *technical advice* to *political decision-makers* – often through well-developed ‘private office’ and ‘private secretary’ systems (see the example of Germany, below). While the private secretary for the finance minister in a developing country may be little more than a clerical role, in countries like the UK and Germany, they are active in managing the flow of technical advice from policy staff to the minister and ensuring that political decisions are transmitted the other way. Indeed, in the UK, these are prestigious positions with good opportunities for later promotion. A well-functioning link between the technical and political levels ensures that the challenge function can be delegated to technical officials while retaining a link to political decision-making over the direction of policy.

Some low- or middle-income countries are unlikely to have (or even need) such a large dedicated team to manage internal political communication. Sufficiently staffing the budget office may be challenging enough. However, the key point to draw from this comparison is the importance of having a bridge between technical advice from officials and political decisions from ministers in order to support the challenge function.

Box 4: Spending teams in the HM Treasury

HM Treasury holds a special status in the UK government administration, with considerable involvement in the development of policy in line ministries. This stems at least partly from the Treasury’s historical powers to authorise all spending commitments before they are formalised through the legislature. The Chancellor and Chief Secretary to the Treasury are represented in the Cabinet, and are important political appointments.

The challenge function is mainly exercised through ‘spending teams’ dedicated to specific ministries or areas of welfare spending. A team managing a large ministry such as health would comprise around 15 staff, and sub-units of two or three policy officers would be dedicated to specific policy issues or sub-sections of spending. They would develop a measure of expertise until they are rotated to other posts (usually every two to three years).

The Treasury formally engages with all department spending policies every three years through a Spending Review, which agrees aggregate expenditure totals and key policy reforms. This is the point at which policies are most likely to change and when the role of the challenge function becomes more active (see NAO, 2012 for a review of Spending Review processes). The work of spending teams is guided by a number of tools, including the ‘Green Book’, which provides a framework for analysing policy options.

Outside of ‘set piece’ events like the Spending Review, policy officers maintain regular communication with staff working in line ministries on their area. Often this means meeting on a weekly basis to discuss problems and important reforms, including the views of their respective ministers. This intelligence is used alongside desk-based analysis of key spending data, consultations with experts and other government staff and formal submissions from line ministries to advise senior staff and ministers on spending and policy options and to request high-level policy direction. Issues are only escalated to formal bilateral inter-ministerial negotiations if they cannot be resolved at this relatively junior level.

For a longer discussion see: Welham, 2016

1.4.3 Managing internal incentives and policy coherence

Operating a challenge function also requires systems *within a finance ministry* to ensure policy coherence across the finance ministry and coordinate the actions of the outward-facing teams or individuals. Again, the exact nature of the structure will vary between finance ministries, but one common configuration is the use of a team or department designed to coordinate overall expenditure management within the finance ministry. In practice, desk officers and/or spending teams may have incentives to defend their own policy area and, in some cases, adopt some of their line ministry's agenda within the finance ministry (sometimes called 'going native'). As a result, some central spending unit will need to have the ultimate 'challenge function' and make final recommendations to ministers on actions to take, even when different parts of the finance ministry's expenditure managers are in conflict (see CABRI, 2006). As examples, this role is played by the 'General Affairs' unit in Germany and the 'General Expenditure Policy' team in the UK.

An increasingly common tool used by many finance ministries is institutionally independent bodies to add strength to their challenge function. While these seemingly constrain finance ministry action by operating independently, they are often used as mechanisms to deliver better policy in the long term by removing short-termist (perhaps political) biases in key finance ministry processes. This removal of bias can be used to strengthen the technical hand of the finance ministry in resolving the 'common pool' challenge. In Kenya, Uganda and South Africa there are also dedicated organisations and rules to govern the share and distribution of resources between central and sub-national governments. Some countries, like the UK, employ independent committees or commissions under specific terms of reference to consider difficult or highly political spending policy areas, such as pensions or public sector pay. Another common global example is a 'fiscal council' that sets external limits on overall spending (IMF, 2013). Many finance ministries also use fiscal rules, such as those employed in Chile and Germany, to impose high-level budget constraints that are managed or reviewed from outside the ministry (e.g. office of the auditor general or an independent panel) as a way of delivering their challenge function. However, there is evidence that the effectiveness of such institutions depends on the nature of the broader political context (Hagemann, 2011).

Box 5: Considering a new spending request in Germany

A number of factors will determine how a new spending request from a line ministry will be treated by the German finance ministry. These are discussed in more detail in Fleischer (2016).

Political factors:

- Whether the spending ministry is led by a minister of the Finance Minister's party.

Policy or fiscal control factors:

- Whether the new spending request relates to (newly introduced) legally fixed services (i.e. the government initiated a new policy requiring a certain expenditure) or not.
- Whether the policy requiring the new spending request is incorporated in the coalition agreement or not.
- Whether the new spending request refers to operating or staff expenditures.
- Whether the spending ministry has performed appropriately in the past (also regarding the medium-term financial plan).

Process compliance and timing factors:

- Whether the spending request is put forward before or after the cabinet decision on the benchmarks for the next year's annual budget.
- Whether it is issued at the beginning or the end of a legislative period.

Source: Fleischer (2016)

1.5 Tools and techniques that could support a challenge function for individuals and for organisations

This section sets out a 'long list' of possible tools and techniques that could be used to support the development of a policy and expenditure control challenge function. The aim is to provide a menu of possible options on which reformers could undertake further research. As noted extensively above, any tool or technique designed to bolster a challenge function needs to be carefully considered in light of the broader context. As is highlighted in general discussion on institutional change in developing countries

(e.g. Andrews, 2013; Booth and Unsworth, 2014), or in specific discussions of expenditure policy reform (Wilhelm and Krause, 2008) adoption of new institutional tools will only be effective if they are adapted to, and informed by, local contexts.

The selection of tools will need to match the capabilities and resources of the finance ministry. There is no ideal or fixed set that must be adopted. Nor will a ministry have the time or resources to use them all. It is usually sensible to focus on those areas that matter most, for example where expenditure is concentrated (e.g. large spending ministries, the public sector workforce, large revenue collectors) or where the finance ministry might have the strongest legitimacy (e.g. in issue of aggregate spending control, or policy decisions with direct spending implications). Some suggested tools (e.g. Public Expenditure Tracking Surveys or Public Expenditure Reviews) have clear guidelines and methodologies that can be adapted to the local context. Others (such as obtaining political buy-in to spending totals) do not have such clear pre-existing ‘handbooks’ and will require locally adapted knowledge.

Some suggested tools may be particularly difficult to implement in low-income and low-capability settings. For example, most low-income countries have struggled for one reason or another to establish credible medium-term budget allocations, and in many even the annual budget is a weak guide for how budgets will be spent in the year ahead (World Bank, 2013; Simson and Welham, 2014).

Equally, despite the great demand to make budgets ‘more strategic’, reforms aiming to achieve this in even OECD countries have often had limited impact (Andrews, 2007).

1.5.1 A ‘long list’ of tools for exercising a challenge function

Table 2 below sets out a list of possible tools, techniques and practices that might support the operation of a challenge function for expenditure management across the two areas of process compliance and policy challenge. These are set against the four classic stages of the budget cycle (strategy formulation and preparation; execution; monitoring and reporting; audit and scrutiny) in order to generate list of possible tools. It considers both types of challenge functions described in section 1.2 – recognising that the finance ministry will be more effective at engaging with line ministries when it can employ a combination of incentives and support mechanisms.

The list is drawn from both a review of the literature and the experience of PFM reform advisers working in fragile states. The list does not attempt to put forward the advantages, disadvantages and methods of operation of each suggested item. As noted, it is outlined as a ‘menu of possible options’ from which country governments and their supports could choose possible candidates on which to undertake further research. It is followed by more detail on the kinds of questions and data analysis that may be useful for policy analysis.

Table 2: Examples of tools available for delivering different parts of the challenge function role of the finance ministry across the stages of the budget cycle

Type of Challenge Function	Stage of the budget cycle			
	Budget strategy formulation and detailed budget preparation	Budget execution	Monitoring and reporting	Audit and scrutiny
Compliance	<p>Detailed and timely budget circular</p> <p>Clear and timely budget calendar</p> <p>Timely distribution of user-friendly templates for technical information</p> <p>Training on new/reformed systems</p> <p>Clear outlining of expenditure ceilings to line ministries</p> <p>Establish rules for public investment so only capital investment projects approved by the finance ministry can be included in the budget and receive funding.</p> <p>Obtain early high-level political buy-in to key expenditure totals and communicate these clearly to line ministries.</p>	<p>Link performance on compliance to future disbursements or levels of autonomy (e.g. higher/lower delegated limits in exchange for effective/ ineffective monitoring and reporting).</p> <p>Deploy own staff to work on execution processes in major line ministries.</p> <p>Establish clear protocols in financial management systems to stop spending above a certain finance ministry-controlled limit, either in aggregate or on key sub-items.</p> <p>Use delegated limits on discrete items of spending to allow for greater oversight (e.g. all payments above a certain level must be signed off by the finance ministry).</p> <p>Quarterly meetings/reviews of budget performance (combined with review of policy issues, as below).</p> <p>Cabinet or presidential updates on monthly/quarterly spending by agency with deviations/overspending clearly noted.</p>	<p>Require that line ministries compile their own monthly/quarterly budget execution reports to varying degrees of detail as a means of encouraging their engagement with the detail of spending.</p> <p>Link performance on reporting to future disbursement and/or levels of delegated authority.</p> <p>Provide rapid and clear feedback to line ministries on the quality and effectiveness of their budget monitoring and reporting work.</p> <p>Require that line ministries produce their own weekly/monthly reports on expenditure.</p> <p>Link the size of future disbursements to evidence of effective monitoring of current spending.</p>	<p>Link performance on audit follow up to future disbursement and/or levels of delegated authority.</p>
Policy engagement	<p>Use finance ministry link to donors/ IMF to reiterate the importance of respecting key expenditure ceilings.</p> <p>Obtain cabinet buy-in/involvement on overall prioritisation of spending.</p> <p>If a realistic national development plan exists, use this as the basis for arguing for certain allocation patterns across government.</p> <p>Set basic criteria for evaluating spending requests and costing capital projects, public-private partnerships and other long-term commitments, such as the wage bill.</p> <p>Undertake analysis on previous year's budget performance to support negotiations with line ministries this year.</p> <p>Agree alongside final allocations to large ministries a set of key policy reforms.</p> <p>Establish special cabinet committees or stakeholder working groups to review complex or highly political policy areas.</p> <p>Request donor support for analysis of key policy areas and options.</p>	<p>Link disbursements of funding or increase/decrease of delegated spending limits to adherence and/or delivery of key policy reform conditions.</p> <p>For key policy spending areas, request bespoke expenditure reports from line ministries.</p>	<p>Quarterly review of progress against policy reform agenda communicated to cabinet/ president.</p>	<p>Produce an end-of-year budget report for cabinet/president to clearly highlight where deviations have occurred and show where poor/good performance has occurred on spending and policy implementation.</p> <p>Commission Public Expenditure Tracking Survey or Public Expenditure Review studies in relevant areas to inform future spending allocations and stimulate policy dialogue.</p>

Box 6: Canada's 'Program Review' in the 1990s

In the early 1990s, a newly elected government in Canada introduced a public spending and public sector reform strategy called '*Government Renewal*'. This aimed, among other things, to: reduce federal expenditures; improve efficiency and effectiveness of expenditure; and clarify the core responsibilities of the federal government in relation to other levels of government.

One of the mechanisms to implement this strategy was a 'Program Review'. This asked ministries, departments and agencies to subject their spending programmes to six tests to help determine the value-added of federal programmes. In this particular model, the burden of proof lay with programme managers, who would need to demonstrate that their programme met these tests if they wish to defend it from cuts demanded by budget deficit reduction strategies. The six tests were designed in a particular order to encourage higher-level questions to come first (e.g. 'is this programme in the public interest at all?') followed by tests that focus more on method of implementation and cost-effectiveness (e.g. which level of government should deliver it, and could it be more efficient?).

Test	Purpose
Public Interest	Does the programme area or activity continue to serve a public interest?
Role of Government	Is there a legitimate and necessary role for government in this programme area or activity?
Federalism	Is the current role of the federal government appropriate, or is the programme a candidate for realignment with the provinces?
Partnership	What activities or programmes should or could be transferred in whole or in part to the private or voluntary sector?
Efficiency	If the programme or activity continues, how could its efficiency be improved?
Affordability	Is the resultant package of programmes and activities affordable within the fiscal restraint? If not, what programmes or activities should be abandoned?

The particular tests are unlikely to all be directly applicable to all fragile state contexts, and it is likely to be unrealistic to subject all government programmes to this kind of questioning. However, these tests set out an example of the kind of questions that finance ministries might ask line ministries to consider when they are proposing new policies or expenditure.

Source: Adapted from Paquet and Shepherd (1996) and Bourgon (2009)

1.5.2 Approaches to policy and budget analysis

When most officials think of a challenge function, they think about the analytical tools and methods for reviewing spending choices and policy. While there is no single 'handbook' for operating a policy challenge function, there are a number of sources which may help in spending or policy analysis, or set out how to organise a 'decision tree' to guide policy challenge processes. For example, Canada standardised the approach to policy analysis and challenge in the 1990s 'Program Review' (see Box 6, above). Other countries have a guiding framework to help policymakers cover key issues, as the UK Government does with its 'Green Book' on investment appraisal. In contrast, South Africa's National Treasury has historically allowed staff to find their own approaches, though it has issued common guidelines for public-private partnerships and budget preparation (Krause and Mustapha, 2016).

There is also a large literature on theories and methods for specific types of policy analysis that could be deployed in a policy challenge function. Some examples are provided in the annotated bibliography, such as approaches to cost analysis. In practice, finance ministries in most low-income and fragile states will not be able to conduct comprehensive and thorough policy reviews, and even in advanced economies policy staff may also draw on technical work from domestic and international think tanks, academics or other sources. It is more likely that the focus of the challenge will be on specific lines of the budget where information is available. In this case, even relatively simple analysis can provide a basis for challenging line ministries' requests. Some of these basic calculations are identified by CABRI (2006) and listed in Box 7.

Box 7: Analysis to help exercise a challenge function

Examples of the kind of standard analysis of expenditure patterns recommended by CABRI (2006) include the following:

- Calculating *real growth in allocations* at different levels to assess whether allocations are keeping up with the cost of providing services.
- Comparing *original budgets to actual spending* and analysing how and when spending allocations change during the year. This will reveal the quality of an agency's internal budgeting processes (for example, are some areas or types of spending consistently under- or over-budgeted?)
- Monitoring *changes in spending* in different sectors and calculating how additional resources have been allocated to shift (or maintain) overall spending shares.
- Calculating the *unit cost* of outputs and how this changes over time.
- Calculating the *cost of providing services per beneficiary*, how this changes over time and how it is affected going forward.

In addition, the questions below – while not an exhaustive list – may usefully inform budget officers when faced with a new spending request:

- Does spending set a new precedent or a financial commitment that will be hard to reverse (for political, technical, legal reasons)?
- Does the policy create any significant fiscal risks?
- Is the policy consistent with government strategic plans?
- To what degree is this proposal a priority, according to those plans?
- Is the level of resources proposed commensurate with the priority rating of this policy within government's plans?
- What is the overall objective of the policy, and what would be the alternative options for delivery of the same objective – have all options been fully considered?
- Does the policy directly affect other aspects of the macroeconomic or policy environment (e.g. tax base, inflation, growth, employment)?
- Who will lose or benefit from the policy, and by how much? Has any distributional analysis been done?
- Does the agency have the capacity to deliver the policy change?
- Is the policy or proposed expenditure consistent with the government's systems of central and local government fiscal relations?

Source: CABRI (2006) and authors' representation

1.6 Approaching the application of the theories and tools available

Establishing an effective challenge function will be difficult in any context. Since institutional arrangements are different, it will not be straightforward to simply copy systems from other countries. Instead, the aim is to get the right fit, with the appropriate organisational arrangements, staffing and information requirements for the context concerned.

A useful first step is for the finance ministry to clarify what it considers its existing challenge function procedures to be (e.g. Fölscher, 2006). This can give a sense of what is already working well, what needs revision, and why. It is worth bearing in mind that the concepts, ideas and language used by the finance ministry in considering its challenge function may be very different from that used by line ministries. This means that initial engagement can be a useful opportunity to make sure all institutions involved are 'on the same page' and using the same language when discussing new procedures. For example, one of the main points of a USAID toolkit for PFM and its links to health outcomes is not to set out new approaches, but simply to help establish a common language for institutional engagement (Kanthor and Erickson, 2013).

Prioritisation of effort will be important in the difficult political, economic and bureaucratic contexts of low-income and low-capacity finance ministries. In some cases, simply maintaining an understanding of the government's basic fiscal position and 'the bottom line' might absorb available finance ministry capability, leaving policy decisions and the degree of adherence with detailed expenditure rules largely to line ministries. Decisions on the nature of the challenge function will have to be highly prioritised, and will depend on the problems that need solving most urgently.

The finance ministry will also need to consider the ability of its stakeholders to engage with a stronger challenge function. Typically, the finance ministry tends to be of a higher level of capability than line ministries.³ This could lead to a circumstance where the finance ministry is ready to deploy numerous sophisticated tools to deliver its challenge function – but the partner line ministry is simply not capable of engaging or responding at the same level. This might mean the finance ministry: reducing its level of ambition and keeping challenge mechanisms simple; communicating the new challenge processes more clearly and effectively; and/or proactively investing in the capability of key line ministries itself (for example, by deploying its own staff to budget and finance functions of larger ministries or engaging in intensive training of line ministry staff).

3. This is a relevant theme in case studies of finance ministries. Weak capacity in line ministries was a limiting factor on the finance ministries' challenge function in Mexico, South Africa and Sierra Leone (Dussauge-Laguna and Vázquez-Luna, 2016; Krause and Mustapha, 2016; Welham and Hadley, 2016). Kraan (2015) also shows that the role of the financial managers in line ministries in the Netherlands differs substantially from those in Croatia and Slovenia, with consequences for fiscal discipline.

1.6.1 Timing and sequencing

The finance ministry will need to think carefully about when and in what sequence it will deploy these techniques and tools, and how best to engage line ministries. Current theories on institutional reform in developing countries suggest taking an iterative and cautious approach that seeks to adapt and learn from gradual reform (e.g. Andrews, 2013; Williamson, 2015). They note that externally-supplied technical assistance can be useful, but such interventions need to be carefully designed and adapted to local context. This would suggest taking some basic challenge function practices, adapting them to the local context and testing them before rolling out to full implementation. It may be possible to test certain tools on particular line ministries (perhaps more capable ones with a reform-minded leadership) or to apply certain tools to certain parts of spending (for example, introducing a stronger challenge to payroll addition or capital expenditure first, and then extending it to other parts of spending later).

A key consideration is whether to build such tools into daily operations, into the annual budget cycle or use them in an *ad hoc* manner. Reviewing the list of possible tools and techniques suggests certain activities have different ways of being built into the challenge process:

- *The annual budget cycle.* Specific challenge points can be built into the budget cycle for all ministries or for selected priority ministries. Once a challenge function is built in, it may need to be repeated over several cycles for it to be accepted and institutionalised. It may also need several iterations and revisions over budget cycles until the optimum process is adopted.
- *Ongoing operations.* Investments in a challenge point can involve building capacity in day-to-day operations. This could involve, for example, nominating staff to be desk officers for specific line ministries prioritised by size and gradually developing some routine work activities for these officers that begin to establish a challenge function (for example, monthly gathering of expenditure data, collating a list of all capital expenditure projects for their nominated ministry or other basic information required to engage in a challenge function).
- *Ad hoc events and policies.* Some challenge function events will not be part of the budget process or day-to-day operations. These could include specific analytical studies, or intensive engagement with certain ministries on key policy areas where the finance ministry has interest. For some of these kinds of events, for example analytical studies, donor funding could be accessed to support delivery. The political cycle – for example the first year of a newly-elected president or newly-formed government – might offer the right political environment in which to exercise the challenge function in order to review current budget and expenditure priorities and practices.

1.6.2 The skills and capacity of staff delivering the challenge function

One of the most important considerations in attempting to institute a stronger challenge function will relate to the capacity of finance ministry staff, the capacity of the financial and other systems they have available and – ultimately – the ability of managers to turn these into institutional *capability* given the context. Many developing country finance ministries show enduring weaknesses in the key areas of recruiting and retaining skilled staff and managing the workforce to deliver effective performance (World Bank, 2013). Even expertly designed challenge function procedures are unlikely to work if the finance ministry does not have the right staff to manage and execute them effectively. In terms of operating with the quality and quantity of staff that is available, reforms to strengthen the challenge function are likely to involve some degree of formal and informal training and capacity development among staff expected to implement it.

This is easily shown in a comparison of the finance ministries of Tonga and Kiribati, which are both small island states in the Pacific (Haque et al., 2016). Though both face challenges recruiting certain skills, around 65% of Tonga's finance ministry is staffed by graduates, while just 20% of staff in the finance ministry in Kiribati have been educated beyond a high school diploma. This difference showed clearly in the analytical capabilities of the finance ministries and in the work that they can deliver. In Tonga there is an emerging policy challenge function, while almost all finance staff in Kiribati are engaged primarily in processing day-to-day transactions. In Kiribati, the policy function is mainly exercised by a few senior civil servants, or by external consultants. The reliance on a small number of individuals places greater focus on urgent demands – from politicians, line ministries or donors – which are typically focused on individual transactions rather than long-term policy analysis.

The discussion above has noted that finance ministries tend to attract more capable staff than line ministries. This will help support effective challenge functions. However, it is frequently the case that other central government bodies pay higher salaries than finance ministries (e.g. central banks, semi-autonomous government agencies, national auditors, state-owned enterprises etc.) (Allen et al., 2015); and private sector competitors substantially more. It is beyond the scope of this paper to discuss how finance ministries can attract and retain the right level of staff capacity, and each country context will be different in the pay and reward incentives that suitably qualified staff face. However, finding a way to recruit and retain capable, skilled and motivated staff is likely to be instrumental – if not critical – to effective operation of any of the challenge functions discussed above.

Box 8: Recruiting, training and retaining capable staff in finance ministry positions

Many developing countries have specifically tried to attract and retain capable staff in finance ministries using different means.

In Sierra Leone, donors initially paid salaries above the official government pay scale to 'Local Technical Assistants' who filled senior level line positions in the finance ministry in the immediate aftermath of the war. Most of these staff eventually transferred on their higher wages to the government payroll. They remained in their senior positions within the institution.

In Mozambique, senior managers within the finance ministry proactively identified capable junior staff with the intention of investing in their development through special assignments and rapid promotion. Over the years, these staff have some to take senior positions in the finance ministry.

In Uganda, a donor financial management programme (FINMAP) recruited and paid for 45 junior consultants to support the introduction of a new budgeting system. By 2012 around 15 had been absorbed into the civil service, but a lack of job openings has prevented more from being allocated permanent posts.

Source: Welham and Hadley (2016); Welham (2014); Simon and Wabwire (2016)

2. Annotated bibliography of key sources

2.1 Literature on the challenge function

CABRI (2006) *Bridging the gap from policies to budget*. 3rd Annual CABRI Seminar 28-30 November, Addis Ababa, Ethiopia. CABRI Secretariat.

Chapter 5 directly addresses the ‘challenge function’ in developing countries, though other chapters are also relevant. It describes how some countries manage their ‘macro controls’ through top-down ceilings and Medium-Term Expenditure Frameworks, although these may not be appropriate in every context. However, it also gives practical illustrations of how the challenge function is organised in finance ministries and examples of information that is useful for challenging budget submissions. The paper is accompanied by presentations on the budget process in a number of African states.

Chapter 2 also provides a useful review of the policymaking process in South Africa, which includes a discussion of the role of senior civil servants in the South African National Treasury.

Krause, P. and Hadley, S. (2016) *Building a more capable public financial management system in Vietnam*. Overseas Development Institute: London.

This paper attempts to frame how the PFM system in Vietnam is likely to change as the country moves towards middle-income country status. In section 3 it applies the academic literature on fiscal controls and policy challenge to the specific context of Vietnam. The approach is high-level and does not give specific recommendations for how the challenge function will be organised, but will be useful for practitioners who want to understand more about how some of the theories listed in this introductory guide can be applied in their own country context.

Diamond, J. (2013) ‘Policy formulation and the budget process’. In R. Allen, R. Hemming and B. Potter (eds.), *The international handbook of public financial management* (pp. 193-218). London: Palgrave Macmillan.

This book chapter gives a useful overview of the policy process in the context of the annual budget and highlights which institutional constraints can make the link between policy and budgeting difficult to achieve. It provides a logical approach to understanding key issues and

establishing the critical relationships while explaining a hierarchy of process compliance, fiscal control and policy effectiveness. The recommendations to address the issues identified include the ‘standard’ IMF and World Bank suggestions of top-down budgeting, multi-year budgeting and commitment management, and the use of performance information.

Robinson, M. (2014) ‘Spending reviews’, *OECD Journal on Budgeting*, 13(2): 81-122.

A free-to-read online paper on the use of ‘spending reviews’ in OECD countries – mainly in Europe. Spending reviews are tools in the budget process for interrogating the quality of line ministry spending allocations and policies. Though not directly informing the debate on the ‘challenge function’, this paper shows that many of the challenges in low-income countries (limited impact on allocations, tendencies for line ministries to overestimate, etc.) are common in OECD countries as well and that making budgets more policy-oriented is difficult. Equally, it is clear that the effectiveness of a spending review process can increase or wane over time depending on the political mood of the day.

2.2 Collections of papers on the budget process

OECD Journal on Budgeting

This free-to-access journal has been running since 2001 and has both case studies of specific countries and cross-cutting reviews on topical issues. Authors are a combination of academics and government officials.

Most of the case material is focused on OECD countries and begins with the title ‘Budgeting in...’ but there are occasional issues dedicated to developing countries (e.g. No.2 of 2006/7) and loose case studies covering countries such as Thailand, China, South Africa and the Philippines. While interesting in their own right, case studies usually focus on budget reforms or fiscal consolidation efforts rather than go into detail on the way the challenge function works. Instead they consistently highlight the very political nature of budgeting.

Some of the cross-cutting papers in this series have relevance to the challenge function:

- Schick, A. 2001. 'The changing role of the central budget office'. Vol 1 (1) 2001/02
- Tarschys, D. 2009. 'The challenge of decremental budgeting'. Vol 8 (2) 2009
- Hawksworth, I. and Klepshvik, K. 2013. 'Budgeting levers, strategic agility and the use of performance budgeting in 2011/12'. Vol 13 (1) 2013
- Robinson, M. 2014. 'Spending reviews'. Vol 13 (2) 2013 (described above)

ODI Capabilities of finance ministries series

Published in 2016, this series of case studies provides information on the finance ministries of Sierra Leone, Uganda, Nepal, South Africa, Mexico, the UK and Germany. Though the coverage varies, each discusses the process for considering a spending request submitted by a line ministry, providing examples of the challenge function in practice. A synthesis paper discusses some of the common themes that influence the capabilities of these finance ministries. There is also a paper on the finance ministry in Chile that follows a different structure, but illustrates one of the most unusual models for delivering an effective challenge function.

2.3 Documents for policy management

Bourgon, J. (2009) *Program review: the government of Canada's experience eliminating the deficit, 1994-99: a Canadian case study*. London: Institute for Government.

A brief discussion of the Program Review in Canada is provided in section 3. It covers both the 'decision tree' approach to deciding where to cut public spending, and the organisational structures that supported it. It is one of the best examples of a coherent and successful application of the challenge function to reduce public spending in the OECD, but also shows that there are many political factors that enabled this success.

HM Treasury. 2011. *The Green Book*. London: HM Treasury.

The Green Book is the UK Government's technical guidance for preparing and evaluating investment decisions. The Green Book website supplements this with specific guidance on preparing cost-benefit analysis and impact assessments. The guidance is an example of 'best practice' and may therefore need to be adapted for use in low-income countries. Nonetheless, it provides a useful reference for the kind of issues that a policy challenge function can consider. This could be read in conjunction with the note on Assessing Business Cases or the Checklist for Assessment of Business Cases.

Pradhan, S. 1996. *Evaluating public spending: a framework for public expenditure reviews*. Washington, DC: The World Bank.

Despite being two decades old, the online guidance provided by the World Bank for conducting public expenditure reviews remains a useful tool. The sectoral focus is relatively narrow – on health, education, agriculture and infrastructure – but the principles can be applied to other sectors as well. It notes that a full expenditure review is not needed each year, but the broad approach may be useful for regularly gathering the relevant information and establishing basic criteria to challenge line ministry budgets.

Potter, B. H. and Diamond, J. (1999) *Guidelines for public expenditure management*, Washington, DC: International Monetary Fund.

These guidelines were designed to help IMF economists understand basic expenditure management principles and how public expenditure management influences the macro economy. Section 2 on 'Expenditure aggregates and data sources' discusses important issues related to analysing fiscal management – such as the coverage of the budget, key sources of data available and the process for making short-term expenditure projections. The discussion focuses on the issues of importance to the mandate of the IMF rather than the broader responsibilities of the finance ministry, though there are naturally some overlaps.

Bardach, E. (2012) *A practical guide for policy analysis: the eightfold path to more effective problem solving (4th edition)*. Los Angeles CA: CQ Press.

An easy-to-read guide to policy analysis that emerged from a university course on public policy. It combines a structured way of thinking through issues, with clear examples and important pointers on communicating to the target audience. It goes beyond the usual hard analytical methods (which are given as references to other books and papers) to emphasise the benefits of using analogies to explain problems, simplifying the world of alternative options, and the importance of looking around at how things work elsewhere.

Bourguignon, F. and da Silva, L. A. P. (eds) (2003). *The impact of economic policies on poverty and income distribution: evaluative techniques and tools*. Oxford: Oxford University Press.

This book provides more detail on specific evaluative techniques, and includes a discussion of tax and benefit incidence analysis and of public expenditure tracking surveys.

McEwan, P. J. (2012) 'Cost-effectiveness analysis of education and health interventions in developing countries'. *Journal of Development Effectiveness*, 4(2): 189-213.

A short journal article on the pros and cons of conducting various kinds of benefit analysis, including cost-benefit, cost-effectiveness and cost-utility analysis. It includes the basic maths and considerations underpinning each and argues that cost-effectiveness analysis is a useful tool even if it is not as sophisticated as a full cost-benefit analysis.

2.4 Documents from policy analysts

Some finance ministries (such as New Zealand's) also publish impact assessments and formal consultation documents which outline key assumptions and approaches to policy analysis. In some cases (such as the UK Green Book) the background guidelines may also be available. These could be highly varied and include elements such as distributional analysis which may be relevant in some low-income countries.

Other institutions also publish their approaches to analysing public policy decisions, which may be useful to draw on. These include, but are certainly not limited to:

- Netherlands Bureau for Economic Policy Analysis
- South Africa's Financial and Fiscal Commission
- UK Institute of Fiscal Studies
- UK National Audit Office
- UK Office of Budget Responsibility
- USA Congressional Budget Office.

Note that these are relatively complex guidelines, often couched in the government's own public policy language and concepts. It is unlikely that they could be directly replicated in most low-income countries. However, if they can be simplified and translated to fit the local institutional language and context, the frameworks may provide a useful guidance to ministers and senior officials in the finance ministry on policy choices.

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Overseas Development Institute
203 Blackfriars Road
London SE1 8NJ
Tel +44 (0) 20 7922 0300
Fax +44 (0) 20 7922 0399

odi.org