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Public Finance and Economic Growth in Developing Countries

Lessons from Ethiopia's reforms

Stephen B. Peterson

Public Finance and Economic Growth in Developing Countries

Public finance is crucial to a country's economic growth, yet successful reform of public finances has been rare. Ethiopia is an example of a country that undertook comprehensive reform of its core financial systems, independent of the IMF and the World Bank, and successfully transformed itself into one of the fastest-growing economies in Africa.

With Ethiopia's twelve-year reform as its guiding case study, this book presents new analytical frameworks to help governments develop better financial reforms. It shows in detail how four core financial systems—budgeting, accounting, planning, and financial information systems—can be reformed. One of the principal findings presented is that governments must establish basic public financial administration before moving to more sophisticated public financial management. Other key findings include the identification of four strategies of reform (recognize, improve, change, and sustain), the centrality of ongoing learning to the process of reform, and the importance of government ownership of reform.

This book will be of interest to researchers and policymakers concerned with public finance, developmental economics, and African studies.

Stephen B. Peterson is a specialist in public financial management advising governments, international agencies, and donors in the development field. He initiated the Executive Program in Public Financial Management at Harvard University in 1986 and led it until 2010. He has directed two long-term financial reforms (Kenya 1986–94; Ethiopia 1996–2008), managing the collaboration of national and regional governments and international agencies. Dr. Peterson is Professor of Public Finance at the University of Melbourne, Australia.

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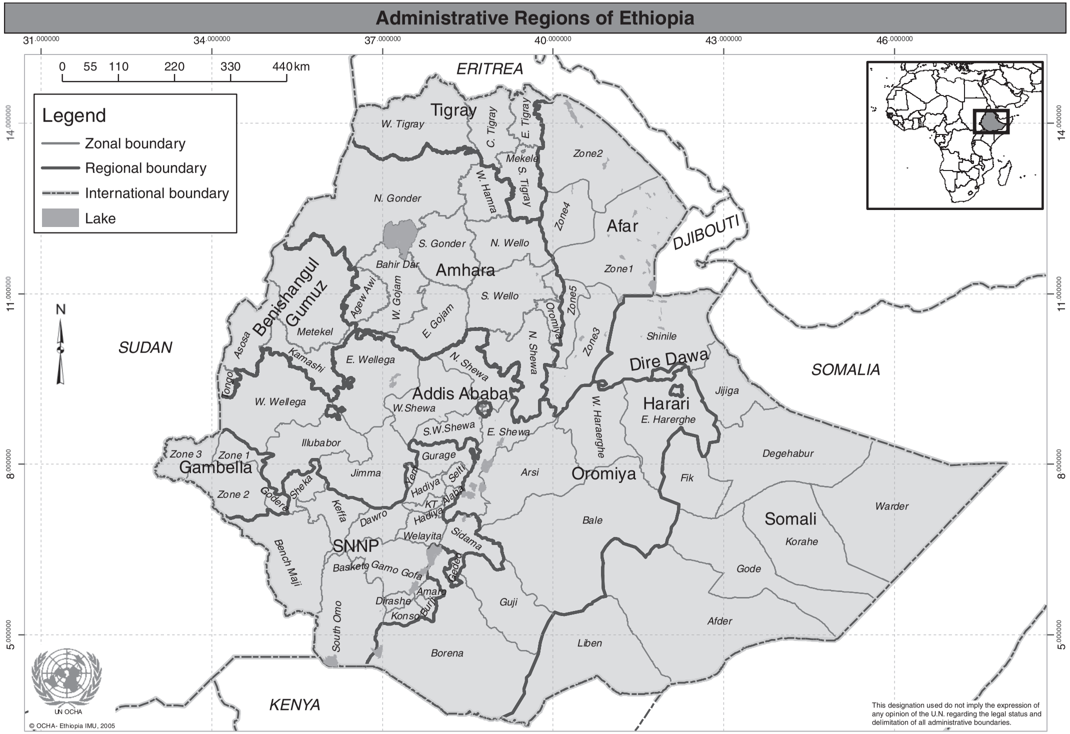
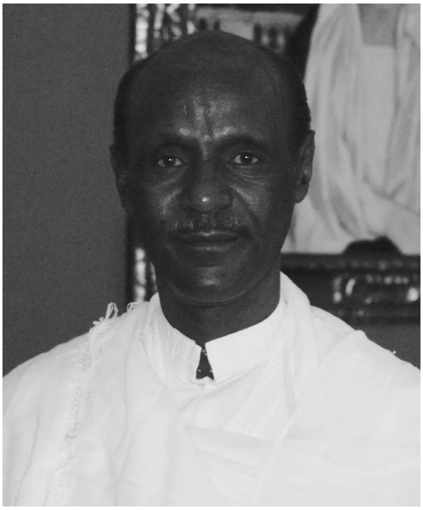


Present-day Ethiopia, known as Abyssynia until 1975, is the second most populous nation in Africa and is home to over eighty ethnic groups. The Christian, Muslim, and Jewish communities of Ethiopia all count among the world's most ancient, and many traditional religions are practiced. The Ethiopian Empire was the only African nation that was never colonized. Map provided courtesy of the UN Office for the Coordination of Humanitarian Affairs. The boundaries and names shown and the designations used on this map do not imply official endorsement or acceptance by the United Nations.

Meles Zenawi (1955–2012), who served Ethiopia as both president (1991–95) and prime minister (1995–2012), at the World Economic Forum Annual meeting in 2012. Meles established the Task Force for Civil Service Reform and took great interest in the reform program's progress, chairing the national steering committee that oversaw implementation of the reform's various programs. He made several key decisions himself—including the decision to exclude the Bretton Woods agencies from the finance reform. Photo copyright by World Economic Forum, swiss-image.ch/Photo by Monika Flueckiger.

The author conferring with Hailemelekot T. Giorgis, vice minister in the Ministry of Finance and Economic Development and chairman of the Expenditure Management and Control Program from 1996 to 2002. Hailemelekot understood that the country faced great challenges and that the reform of its financial management would not be done easily nor quickly. His insights, humor, and relationships with key officials in the federal and regional government promoted trust in the reform. Photo courtesy of Sarah Guebreyes.



Getachew Hamussa (1951–2008), the head of the finance bureau in the Southern Region from 1997 to 2005. His successful direction of that region's financial reform—the first regional implementation of the reform—created a model for other regions to learn from. His fairness and commitment inspired deep loyalty in his staff. He often would show up in the project offices late in the evening after his many other duties to see for himself the progress being made. Photo Corporal Issa Paré, 2006.

Getachew was optimistic about his country's future and communicated it with his boundless enthusiasm. Here he addresses local finance officials of a *wereda* (smaller administrative district). Photo courtesy Kedru Yirga.

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In memory of my parents, Lillian and Lawrence Peterson
Yes, I did return to Africa

The besetting mistake of expert designers is not designing the thing wrong, but designing the wrong thing.

Frederick P. Brooks, Jr., *The Design of Design: Essays from a Computer Scientist*

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Foreword

Fundamental reform of government and economic institutions is always difficult. Even in high-income countries, where the institutions of a market economy function well and governance is generally effective, reform efforts of institutions ranging from schools to welfare programs to government budgets often fail. The impediments to reform are much greater in developing countries, where the human and financial resources to support reform are weak, where societies are often deeply divided by ethnicity and lack of a common language, or by radical differences between the needs and desires of the urban elite, farmers producing subsistence crops, others producing crops for export, and the many migrants who have left the farm to try to find a better future in low-skill urban jobs. In these terms Ethiopia was one of the poorest countries in the world, and its population was an unusually diverse one, even by developing-country standards. And yet the Ethiopian government of the 1990s and the first decade of the twenty-first century was able to carry out a major reform of its public finance institutions. This book is about those reforms, what it took for them to succeed, and what it will take for that earlier success to be sustained.

International aid agencies played a role in these public sector reforms—some did more harm than good, but others provided critical support. In the latter category was USAID, the agency that provided technical assistance from outside the country, most notably in the person of Stephen Peterson, the public finance and management specialist who led the design and implementation of the Decentralization Support Activity (DSA) project and who is the author of this book.

But this book is not about a failed system and a heroic aid agency and an outside advisor who came in to rescue it. The most indispensable ingredient in the reform was that the Ethiopian government took full ownership of it from the beginning and persevered through thick and thin. This government had come to power after a civil war that was combined with famine and then quickly became embroiled in another war as a region of the country broke away to become an independent country, Eritrea. The DSA project itself was complex in that it involved the decentralization of a core public financial system—budgeting, accounting, expenditure planning, and automation—to the many diverse regions of the country. Implementation required training many thousands of budget staff.

The other critical ingredient in the success of this reform program was that the effort was sustained over a long period, with many of the key people, including Peterson, remaining in place throughout the design and full implementation phases, a process that took twelve years. The essence of institutional reform, particularly but not exclusively in developing countries, is that the changes introduced must fit the reality of the country, and it takes time to figure out and test what works and does not work in the country involved. One cannot take a beautifully designed public finance system, designed with the assumption that all the necessary supporting institutions are in place, set it down in a country where many of those supporting institutions do not exist, and expect it to work. In the case of the program described in this book, the very concept of public finance *management* could not be implemented in the Ethiopian context. A more basic public finance *administration* was required. Even that was a complicated challenge, in that it involved linking the capital and recurrent budgets, adapting a system of performance budgeting, changing from single-entry to double-entry bookkeeping, establishing a needs-based unit-cost fiscal transfer system for intraregional transfer, and then automating this whole system with a state-of-the-art financial management information system—state-of-the-art, that is, for an IT system that could function in a vast country with an antiquated, low-bandwidth electronic infrastructure. Along the way the thousands of personnel needed to run this system also had to be trained.

The obvious success of this effort is not the only lesson to be drawn from the reform. The experience of the Ethiopian DSA project also demonstrates the need for both the government and aid agencies supporting its reform to fully understand what has been accomplished and not to attempt to introduce a variety of further reforms without making sure that the existing system can readily integrate them. In Ethiopia, efforts in recent years have been made to introduce sophisticated public finance management systems without much consideration of what the existing system can absorb, and the result has threatened the sustainability of the earlier effort.

Public Finance and Economic Growth in Developing Countries: lessons from Ethiopia's reforms contains a wealth of information that anyone interested in public finance reform and institutional reform in developing countries in general can learn from. It is particularly relevant to such reform efforts in Africa, but many of the principles are equally applicable to developing countries around the world.

Dwight H. Perkins
Harvard University
Cambridge, Massachusetts
November 2014

Preface

In February 1996 I was scheduled to go to Poland to start a reform of that country's tax administration for the U.S. Treasury. My colleague, John Cohen, asked me to make a detour to Ethiopia for two weeks and help him design a reform project for strengthening the country's decentralization. Cohen's extensive fieldwork and research had made him an authority on Ethiopia, and he was the reason the United States Agency for International Development (USAID) had approached Harvard University for assistance in designing the project—the Decentralization Support Activity project. Stevens Tucker, the governance advisor at USAID, had brought in John after doing the groundwork of this reform through his two-year dialogue with the Ethiopian government in 1995 and 1996.

John's cancer diagnosis prevented him from leading the project, and he asked me if I would do it. His conviction that the Ethiopian government was serious about reform was confirmed by what I saw with my own eyes and the people I met in those two weeks. John was right. It was the most promising opportunity I had yet glimpsed to implement a truly effective reform of government finances in a developing country, and I seized the opportunity before me. I never went to Poland—the two weeks turned into twelve years. John's (and my) faith in the Ethiopian government's seriousness of purpose was vindicated: The World Bank has judged Ethiopia's reform to be one of the best on the continent in recent decades.[1]

Backing up a bit, the context of my decision was that financial reforms on the continent and elsewhere have not fared well. For a period of eight years before I arrived in Ethiopia I had been involved with several financial reforms in Kenya that had had virtually no impact. I learned firsthand about foreign aid fads in the field of public financial management as I managed the World Bank project in the Ministry of Agriculture, which introduced to Africa the bank's latest technique in its portfolio of "international best practice," the public investment program (PIP). PIPs were meant to prioritize projects in the capital budget, but failed, in Kenya and elsewhere, because they were based on the premise that allocating public funds—a fundamentally political process—could be guided by a technique. Eventually the PIP went the way of many such fads in PFM: it was discredited and abandoned.

My experience in Kenya confirmed for me the validity of the teachings of the political scientist Aaron Wildavsky, under whom I studied at the University of California, Berkeley. Wildavsky, renowned for his work on public policy, government budgeting, and risk management, had a great deal to say and to teach on the robust nature of simple financial systems—what the field calls today “the basics”—and the difficulty, danger, and often limited value of moving beyond simple.

In 1996 Ethiopia faced enormous challenges as a country: the need to recover from a long civil war and attendant political challenges, extreme poverty, a youthful new government strongly committed to rapid decentralization yet leery of foreign influence. Basic financial systems were the order of the day. Ethiopia offered an unusual situation and an unusual opportunity that led to a significant success in its reform efforts. This experience was formative for me and gave me the opportunity to make a positive contribution to a dynamic aspect of this fascinating country’s development. It also gave me myriad insights into the process of reform that resulted in my creation of a new theoretical model and analytical tools. I integrated these tools into the executive education program I introduced and directed at Harvard University for twenty-four years and was encouraged that these tools resonated with senior officials, from forty-seven countries, who participated in the program.

Especially gratifying was the frequent observation by workshop participants that “what we have [in my own country] is not that bad.” This aligned with my own experience, that understanding context, building on existing assets and strengths, and taking an incremental approach to change were keys to the Ethiopian reform’s success. Thus was planted the seed of the idea to write this book.

To start to fix the problems in the understanding and practice of PFM, countries and practitioners need examples of success—if only to know that it can be done and how it can be done. With this book I offer a work that describes and dissects a significant achievement of a government in Africa that chose its own path to reform its finances. The book provides tools that support the efforts of practitioners as they guide governments in developing countries—indeed, in developed countries as well. Perhaps most important to success in the field in Ethiopia were training materials. Ethiopia’s long political turmoil had decimated the ranks of qualified government personnel, and thousands of competent new staff were needed. Consequently, central to the reform’s success was an extensive training program for finance officials at every level of the administration. My goal of advancing understanding of effective PFM reform includes a commitment to making available for study and emulation the training materials the DSA project and the government developed. To this end the procedural manuals and the training materials based on the manuals are available to download on the author’s website which complements this book (stevepetersonpfm.com).

The eighteen-year effort to design and execute the reform and, later, to write this book about the experience rested on a network of collaborations, some involving a few individuals and others involving thousands. First and foremost is David Leonard, whose thorough work on rural development in Africa has been an inspiration and a standard to me and many others. David shaped my career in international development starting when I was his student at Berkeley, and has assisted me every step of the way. David introduced me to John Cohen, leading to a friendship that was central to my work in Ethiopia. John's research and fieldwork—and his fluency in Amharic—had given him not only a matchless understanding of the deep structure of Ethiopia's society and economy but also an equally deep love of the country's people and appreciation of its extraordinary history and sophisticated Abyssinian culture. Without him there likely would not have been a reform in Ethiopia.

Reforms in developing countries must be funded, by the country's government, foreign aid, or a combination of the two. Financial reforms take years, so patience and continuity of funding are critical. The DSA project was fortunate in its funders. USAID, the reform's largest donor, stayed the course for all twelve years, effectively managing the funding process yet never micromanaging the project. When additional resources were needed, the governments of Ireland and the Netherlands joined USAID as outside funders. In the final and most extensive phase of the project, the Ethiopian government made the largest financial contribution. The collaboration of all four governments made the reform possible.

The reform was won with leadership and commitment from the top through to the trenches. At the very top, Prime Minister Meles Zenawi provided leadership in the early stages of the reform, taking great interest, making key decisions, and guiding the strategy that allowed those in the trenches to be so effective. From the reform's inception, the prime minister made it absolutely clear that this was to be a government, not a foreign aid, reform.

Hailemelekot T. Giorgis, vice minister for finance, was the senior government official tasked with carrying out the reform. A teacher by training, he appreciated the obstacles confronting the reform and the need for patient learning.

Among many other officials who made enormous contributions, Getachew Hamussa, the head of finance in the Southern Region, stands out. Ethiopia's deep decentralization meant that success hinged on the reform's working in the regions and their smallest budgetary entities, the *weredas*. The Southern Region is one of the largest of Ethiopia's nine regions, and it was the site of the first regional pilot of the reform.[2] Success in this large region would do much to launch the reform nationwide. Getachew's leadership in the Southern Region ensured the success of his country's reform.

Reform is won or lost in the trenches and the trenches delivered. Most deserving of acknowledgment are the more than 72,000 Ethiopian officials who underwent training and delivered the reform to every level of the country's administration.

Within the DSA project it was a privilege to work with our sixty-three staff members. I wish I had space to thank each one individually. Here I wish to thank most especially four people: Sarah Guebreyes, the project manager, made sure that the project's $34.7 million budget was properly accounted for (we passed four USAID audits). She was also a staunch advocate for making the results of the reform known in the form of a book, and helped keep the facts straight. Jim Yardley played a leading role in designing the in-service training program, and gained the trust of government finance specialists not only with his knowledge but also with his down-to-earth demeanor. James Joseph, a project advisor who possessed a quarter century of experience on the continent, worked tirelessly with project staff and government officials to manage and ensure the quality of the in-service training program that was the foundation of the reform. Mebrahtu Araya, a former government official, ensured that the accounting procedures and training were clear and accessible for government staff. Equally important, through his deep network of contacts with government officials he provided the DSA project with invaluable understanding as to how officials viewed the reform.

Other individuals were pillars of support when it came to writing this book. Bill Trautman, a colleague at the Harvard Institute for International Development, in numerous discussions of the DSA project and the book's most controversial issues brought wisdom from his long experience with both developed and transitional governments on how and why they typically don't work well. He helped convince me that something that worked in Abyssinia under such difficult constraints was important to publish. Helen Solomon, for years the DSA project's backstop at the Kennedy School, understood the challenges of its implementation from a granular perspective and provided an endless supply of enthusiasm for both the project and book. Helen also gave generously of her time to read and provide comments on all of the chapters. My editor, Katherine Scott, took on a project that became much larger than she had anticipated. She stuck with it, bringing not only clarity and structure to the manuscript through our many rounds of reorganizing, rewriting, and editing, but also creative input that shaped the work. Without her, there might have been a book—but not this book. Bill Sweetser, my oldest friend, encouraged and supported me in this undertaking and—engaged in an ambitious writing project of his own—swapped writing stories with me. My colleagues David Leonard, Jerome Dendura, Noel Hepworth, Mick Moore, Mike Westlake, and Jim Yardley read selected chapters and provided feedback that sharpened the manuscript. Dwight Perkins, the director of the Harvard Institute of International Development, hired me in 1986 and has supported my work and my professional goals unstintingly since then. He kindly offered to write the foreword to this volume.

Fortune continued to smile on the project when it found a home in Routledge's Development Economics publishing program. My thanks to Helen Bell and Emily Kindleysides for their initial interest, and to Lisa Thomson and the rest of the Routledge production team for their efficiency and professionalism, ensuring a smooth production process.

My work in Ethiopia and on this book could not have been done without the support of my family: Jennefer, Mara, and Claire. I am grateful for their patience and love.

Stephen B. Peterson
Melbourne, Australia
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Notes

1 For a full discussion of the World Bank's 2010 assessment and recent developments in Ethiopia's financial system, see chapter 8.

2 There are eleven administrative entities below the level of the federal government: nine regional states and two administrative areas. The nine regions are Tigray, Afar, Amhara, Oromia, Somali, Benishangul Gumuz, Harari, Gambella, and the State of Southern Nations, Nationalities, and People's Region, or SNNPR (often called the Southern Region, the usage employed in this book). The two administrative areas are the Addis Ababa City Administration and the Dire Dawa City Administration (www.ethiopia.gov.et/web/pages/regional-states).

Acronyms

BC	budget classification
BDA	budget disbursement accounting
BI	budget institution
BIS	budget information system
BOCB	Bureau of Capacity Building
BOFED	Bureau of Finance and Economic Development
BPR	business process reengineering
BRT	budget reform team
BW	Bretton Woods
CID	Center for International Development
CIDA	Canadian International Development Agency
CIPFA	Chartered Institute of Public Finance and Accountancy
COA	chart of accounts
COFOG	Classification of the Functions of Government (UN)
COPS	context, ownership, purpose, and strategy (drivers of reform)
CPIA	Country Policy and Institutional Assessment
CSRP	Civil Service Reform Program
DFID	Department for International Development (UK)
DoA	Description of Accounts
DSA	Decentralization Support Activity project
ECSC	Ethiopian Civil Service College
EMCP	Expenditure Management and Control Program
EPRDF	Ethiopian People's Revolutionary Democratic Front
FGE	Federal Government of Ethiopia
FIS	financial information system
FMC	financial management and control
HIID	Harvard Institute for International Development
IBEX	Integrated Budget Expenditure (system)
ICT	information communication technology
IFMIS	integrated financial management information system
IFTP	In-Service Financial Training Project
IST	in-service training
IT	information technology

JBAR	Joint Budget and Aid Review
LDSW	locally developed software
MEDAC	Ministry of Economic Development and Cooperation
MEFF	macroeconomic fiscal framework
MOF	Ministry of Finance
MOFED	Ministry of Finance and Economic Development
MTEFs	medium-term expenditure frameworks
NORAD	Norwegian Agency for Development Cooperation
OECD	Organisation for Economic Co-operation and Development
OLF	Oromo Liberation Front
OTS	off the shelf
PEFA	Public Expenditure Financial Accountability (Framework)
PEP	public expenditure program
PFA	public financial administration
PFM	public financial management
PIP	public investment program
PSCAP	Public Sector Capacity Building Project
PSCP	public sector capacity project
PSNP	Productive Safety Nets Program
REPR	regional economic policy review
RMIs	regional management institutes
SIDA	Swedish International Development Agency
SDP	sectoral development program
SNNPR	Southern Nations, Nationalities, and Peoples Regional State
SPVs	special payment vouchers
SSD	second-stage decentralization
TGE	Transitional Government of Ethiopia
TOR	terms of reference
TPLF	Tigrayan People's Liberation Front
USAID	U.S. Agency for International Development
WAN	wide area network
WSU	wereda support unit
ZOFED	Zonal Office of Finance and Economic Development
ZSU	zone support unit
ZTB	zero treasury balance

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Part I

Understanding public financial management reform

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1 The Ethiopian public finance reform—a case study for *Yichalal!*

Efficiency is doing things right, and effectiveness is doing the right thing.

Peter Drucker

The financial reform in Ethiopia that took place between 1998 and 2008 is considered one of the best on the continent of Africa since 2000.[1] It succeeded because the right thing was done right. As a success in a field littered with failures, it is worthy of study, for it demonstrates what it means to do the right thing in a developing country. As a success on a continent where failure is all too common, Ethiopia's financial reform demonstrates that African governments can take the lead in designing and implementing financial reforms—a departure from the foreign aid model so prevalent in Africa. The Ethiopian case provides practical frameworks based on a long-term reform which can untangle the morass of current views on public financial management (PFM). It provides an empirical demonstration of how to carry out a financial reform because it provides insight into something that is usually ignored in the PFM literature: learning and how that is achieved through the effective engagement of technical assistance and the alignment of the roles of officials and advisor.

Although the term of choice in the field is PFM, in fact Ethiopia implemented a reform of public financial administration: PFA, not PFM. The failure to make the distinction between the two is a principal source of confusion about PFM and its reform in developing countries. Many financial reforms have failed because they parachuted techniques in that do not fit with how a government is organized: Is it a bureaucracy with weak administration that must strengthen its PFA? Or a strong bureaucracy that has a sound PFA in place, encourages management, and can thus adopt PFM techniques? Regardless of how the bureaucracy is organized, governments must first have financial administration before attempting financial management. Financial administration is compliance, external control, and ensuring the stewardship of public money. Financial management is about establishing internal control, and promoting discretion to achieve policy. Both PFA and PFM are means, not ends. History shows that development does not require PFM—robust PFA is good enough. Developing countries by definition are countries that lack the preconditions for financial management. For such countries, the objective should be to build a robust PFA. The Ethiopian reform provides insights into the principles and nuances of doing this in four key areas: budgeting, accounting, automating (the establishment of financial information systems), and planning. I discuss this issue in greater detail in chapters 9 and 10.

A case study

Public sector financial reforms typically take at least twelve to fifteen years to implement.[2] For twelve years I was the manager of the technical assistance project that supported Ethiopia's public finance reform. Thus I was not only a firsthand observer, but experienced the reform from the inside. This puts me in an excellent—and unusual—position to present a case study of a reform that I observed over a long period of time.

Several years after the departure of the technical assistance to the reform and the end of the project that I headed, I was able to gain an additional perspective as an external observer when I was asked to return and review the reform's performance. The different ways I experienced Ethiopia's reform over a span of sixteen years—as a consultant, implementer, participant, and ultimately, evaluator of its successes and failures—make this case study a first.

In this book I tell the story of what I learned about implementing PFA and, in that process, about the necessary conditions of successful reform.

Ethiopia's PFA reform was crucial in the government's drive to decentralize service delivery to its weredas (the lowest level of government administration responsible for a budget) and confront the country's abject poverty at its roots. Making decentralization work meant that foreign aid could be significantly ramped up by orders of magnitude to support the government's efforts in poverty alleviation. The reform enabled the country, the largest recipient of World Bank concessionary assistance on the continent, to handle these financial inflows. Better financial administration at the wereda grassroots ensured the success of the government's social protection program, the largest in the world, which was scaled up until it provided assistance to up to 9 million people.

The Ethiopian Public Financial Administration reform provides valuable lessons for other developing countries and also strengthens our ability to generalize appropriately from the reform of their public finance systems. The Ethiopian reform is especially striking because it had to overcome the challengingly low level of the country's development. It also illustrates what "local ownership" really means, and what it can accomplish.

Achievements of Ethiopia's reform

The Ethiopian government accomplished significant achievements in four areas that virtually all developing governments grapple with:

1 *Budgeting*. Two reforms were done. First, the capital and recurrent budgets were linked ("crosswalked," in financial management parlance) with a budget