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MANAGING FIDUCIARY ISSUES IN BUDGET SUPPORT OPERATIONS

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INTRODUCTION

1. Fiduciary issues have been seen as a key factor in budget support operations.¹ But fiduciary risk in particular has been little articulated.² This paper aims to survey and analyze approaches to fiduciary issues and by doing so to clarify and demystify the concept of fiduciary risk. This should assist in the dialogue between donors and development partners on budget support operations. Donor institution country teams in particular, may find this useful.³
2. There appears to be an emerging consensus among major budget support donors that the best assurance that their funds are well managed is through the existence of a sound partner country PFM system. Thus the key issue in analyzing fiduciary risk is the quality of a country's PFM (including procurement) systems. PFM issues have become a key aspect of the policy dialogue between donors and partner countries, reflecting the now recognized importance of sound PFM in poverty reduction – through the ability of a partner country to develop, implement and report on a budget which is comprehensive, realistic, well prioritized (in terms of poverty reduction) and having a medium term focus. The policy dialogue also emphasizes the need for government ownership of and commitment to a PFM reform program
3. A review of donor practices suggests strong emphasis on obtaining diagnostic information/knowledge on the quality of partner countries' PFM system, to inform decisions on budget support. This reflects a view that decisions on budget support operations should be informed by information on fiduciary risk, and approached with "eyes open". DFID's approach in particular, stresses the need for full documentation of the basis on which budget support decisions have been made, to serve as a basis for accountability to taxpayers. The information informs decisions on the size of individual budget support operations, conditionality, tranching and risk mitigation measures. Some, but not all donors have taken the view that fiduciary risk needs to be set out in an explicit statement on areas of risk and/or the overall level of risk, in some cases expressed in narrative terms or even quantified. This paper suggests there is a need to avoid overcomplicating fiduciary issues, in particular in the development of any explicit risk statement or assessment.
4. Clearly, no financial assistance from donors to partner countries can be risk free. And the risks need to be compared with benefits – both in absolute terms and

¹ Budget support operations includes sector budget support and budget support to sub-national governments, where it is intended they be managed through country PFM and Procurement systems.

² As an example, curiously, there is no explicit discussion of fiduciary issues in the 2003 *Evaluation of General Budget Support, Evaluation Framework*, Overseas Development Institute, February 2002, undertaken for a group of donors.

³ For example both the United Kingdom and the Netherlands stress the importance of their operational staff understanding PFM issues. DFID has a program for the training of its staff through How To Notes (so far produced on Direct Budget Support and Supreme Audit Institutions) and Netherlands has a PFM Support Program to train Embassy staff in PFM issues.

comparatively for each form of aid modality. And donors may need to be realistic about how quickly the level of fiduciary risk can be lowered by improved PFM and Procurement systems. Experience suggests that such institutional and systems reforms can only produce results in the medium to long term.

5. Fiduciary risk has been seen as a donor issue. Donors perceive a need for reliable information on how budget support is used and that it is “properly managed and used” – so that they can be accountable to their own taxpayers, and also be able continue this support. But partner countries have the same interest concerning their own funds, as part of the budget. The challenge therefore is to develop this commonality of interest into a country led concern with sound PFM, which is supported by donors, and includes dialogue based on mutual objectives and trust.⁴

THE SIGNIFICANCE OF FIDUCIARY RISK

6. Budget support is seen by some donors as inherently more “risky” than traditional project level support, because of the poor quality of many partner country PFM systems through which, by definition, donor assistance flows –and also since, by definition, it is not possible to track the end use to which the funds are put. Partner country PFM systems have in the past few years been extensively assessed through a range of donor diagnostic work.⁵
7. The risk assessment approaches are based on the quality of the PFM and Procurement systems, along with appropriate anti-corruption diagnostics. There are now generally accepted templates of good PFM and Procurement systems and systematic performance measurement frameworks are under development for both areas which can assist in measuring the quality of the PFM and Procurement systems.⁶
8. In its 2004 review of issues in PFM assessment and reform⁷ PEFA recommended
 - Governments and donors should agree on how to define fiduciary risk

⁴ It can be noted that the Declaration from the Paris High Level Forum on Harmonization, Alignment, Results and Mutual Accountability (March, 2005) includes a commitment by partner countries to take the lead in the reform of PFM and Procurement systems.

⁵ See for example World Bank – Assessing and Reforming Public Financial Management, A New Approach Richard Allen, Salvatore Schiavo-Campo, Thomas Columkill Garry, 2004 and Harmonizing Donor Practices for Effective Aid Delivery, Good Practice Papers, Chapter 3, Measuring Performance in Public Financial Management, DAC Guidelines and Reference Series, OECD 2003 - for a description of this range of donor PFM diagnostic work.

⁶ The work of the Public Expenditure Working Group (World Bank, PEFA and IMF - see later discussion) and the OECD/DAC Procurement Roundtable are of particular note here.

⁷ World Bank – Assessing and Reforming Public Financial Management, A New Approach. Richard Allen, Salvatore Schiavo-Campo, Thomas Columkill Garry, 2004

- the role of assessments in evaluating fiduciary risk and contributing to long-term development goals should be clarified

FIDUCIARY AND DEVELOPMENTAL OBJECTIVES – TWO SIDES OF THE SAME COIN

9. Perhaps more controversially the PEFA study suggested that consideration should be given to splitting the development (improving PFM systems) and fiduciary (assessing the quality of PFM systems to determine the likelihood that funds will be appropriately managed – as input to decisions on budget support operations) aspects of PFM assessments into separate processes and reports– while recognizing that they are both looking at the same issues. This approach appears now not to be accepted by donors; the general view appears to be that PFM development and fiduciary issues are two sides of the same PFM coin and cannot usefully be separated. The same knowledge base about the operation of the PFM system is used for both purposes. For example the World Bank’s CFAA Guidelines⁸ explicitly state the CFAAs, in identifying weaknesses in PFM systems, have both a developmental and a fiduciary objective. Donors and partner countries both have an interest in both. The challenge is to have both work collaboratively to meet both developmental and fiduciary needs, within a partner country led framework. As suggested above, frankness and openness are needed from both donors and partner countries in doing this.

WHAT DO WE MEAN BY FIDUCIARY RISK ?

10. The literature and donor country statements on fiduciary risk vary in their definitions, but generally include all or some of the following
 - the risk that donor funds may not reach the budget – they may be diverted beforehand for unknown or unauthorized purposes. This concern with flow of funds through the partner country’s central bank to the MOF and thus the budget is an explicit aspect of the fiduciary risk approach of the World Bank and previously the EC. This seems a less problematical area, and is discussed separately in paragraph 33 below.
 - the funds reach the budget but there is no reliable and timely reporting on overall budget execution – thus donors do not know how (or perhaps even whether) their funds (as part of the budget) have been spent. Poor fiscal reporting is a major PFM deficiency in many countries.⁹

⁸ Country Financial Accountability Assessment Guidelines to Staff, World Bank, Financial Management Sector Board, May 27, 2003

⁹ The 2004 HIPC Expenditure Tracking Assessment indicated that only 28 percent of countries were able to produce audited financial statements within twelve months of the end of the fiscal year. However this was the major area of PFM improvement revealed by this assessment– up from 18 percent in the previous 2002 assessment. It can be noted that an International Public Sector Accounting Standard (IPSAS) on Disclosure Requirements for Recipients of External Assistance is currently under development by the International Public Sector Accounting Standards Board, at the request of the donor community.

- the funds reach the budget but are misspent, because the budget is not adequately implemented¹⁰ and/or the budget is not sufficiently pro-poor (does not achieve value for money), and/or budget funds (including donor assistance) are used for inappropriate, unauthorized, unknown or “corrupt” purposes.

The quality of the PFM system is again a key issue here; a well functioning PFM system will reduce the risk of such occurrences.

11. We now review the approach of two donors which have the most detailed documentation of their approach to fiduciary issues in budget support – the World Bank and the U.K. Department for International Development (DFID). Other donors which have also documented their approaches include the European Commission, Denmark and Sweden¹¹.

World Bank

12. The Bank’s approach to budget support requires an ex ante assessment of the partner country’s PFM and public procurement systems. The information for this assessment may come from a variety of sources. While the Bank’s CFAAs have been a prime source of information, the Bank’s Public Expenditure Reviews (PERs) and Country Procurement Assessment Reports (CPARs), the IMF’s Report on Observance of Standards and Codes – Fiscal Transparency Module and the joint Bank/IMF HIPC Expenditure Tracking assessments have also been major sources of information. In some cases diagnostic information from other donors has also been used.
13. The Bank has two prime fiduciary concerns in budget support – that the funds reach the budget and that they are “appropriately managed” as part of the country’s budget resources¹². Bank reviews of the above inform decisions about individual budget support amounts, tranching, program content, conditionality and risk mitigation measures.
14. The Bank’s CFAA Guidelines¹³ provide an indicative list of relevant PFM issues to be examined, while noting that their relative importance may depend on the

¹⁰ This covers the situation where donors are required to ensure that their funds are “used for the purposes for which they were intended”, such as applies under the World Bank’s Articles. The formal budget is thus perceived as representing “intended purposes”.

¹¹ European Commission - Guide to Programming and Implementation of Budget Support for Third Countries, March 2003 and Methodological Guidelines for Budget Support: DANIDA - Guidance Note on the Provision of Budget Support, October 2003: SIDA - Programme Support and Public Finance Management; A New Role for Bilateral Donors in Poverty Strategy Work. Sida Studies no. 6, Ulrika Broback and Stefan Sjolander (2002)

¹² From Adjustment Lending to development Policy Lending ;Update of World Bank Policy, World Bank, Operations Policy and Country Services, August 2004 and Good Practice Note 3, Financial Management Issues in Development Policy Lending, October 2004

¹³ Country Financial Accountability Assessment Guidelines to Staff , Financial Management Sector Board May 27, 2003

individual country. The Guidelines discuss *financial management* risk as the probability that the PFM system will not provide appropriate management of all public funds. Key factors contributing to this risk are thus PFM systems issues – including that the budget is not implemented as passed, that there are significant off-budget activities, that there is insufficient reliable and timely information on budget implementation and the financial control rules are not enforced. This financial risk assessment is to draw from an analysis of the overall quality of the PFM system.

15. The Guidelines discuss financial management risk as one component of overall fiduciary risk, the other components being
- procurement risk drawn from the an analysis of the public procurement system (the CPAR) The Bank’s CPAR Procedures¹⁴ provide for discussion of various risk elements, as discussed further in paragraphs 25-27 below
 - the risk of misuse of Bank funds through official corruption, drawn from anti-corruption diagnostics carried out by the World bank and others.

However the Bank has not sought to develop this overall concept of fiduciary risk. Its explicit approach to fiduciary risk covers only the financial management risk, as discussed above.

16. It can be noted that the CFAA approach to fiduciary risk does not include an assessment of whether the expenditure is likely to be appropriately managed in the sense of achieving value for money or focusing on poverty reduction. While this is an important issue in all its budget support operations it is analyzed through the Bank’s Public Expenditure Reviews (PERs) and other diagnostic work, and incorporated as appropriate in the policy issues addressed in each budget support operation. This is not perceived as a “fiduciary” issue and there is no explicit risk assessment.
17. However this issue is included in the HIPC expenditure tracking assessments, carried out in conjunction with the IMF¹⁵ are a diagnostic tool developed in 2000 which cover the ability to track through the PFM system the intended additional pro-poor spending arising from the debt relief granted to the 28 heavily indebted poor countries (HIPC). The sixteen benchmarks analyzing the PFM system include a measure of whether the budget is pro-poor in its focus.

United Kingdom (DFID)

18. The UK approach¹⁶ defines fiduciary risk as the risk that funds

¹⁴ Revised CPAR Procedures, World Bank, April 2002

¹⁵ See IMF and World Bank, Update on the Assessments and Implementation of Action Plans to Strengthen Capacity of HIPCs to Track Poverty Reducing Spending. April 12, 2005

¹⁶ Managing Fiduciary Risk When Providing Direct Budget Support (How To note and Briefing, 22 September, 2004) Department for International Development

- are not used for intended purposes
- do not achieve value for money (economy, efficiency and effectiveness)
- are not properly accounted for

The risk is required to be explicitly discussed, and be outweighed by the perceived benefits if the budget support is to proceed. The DFID approach also indicates that high fiduciary risk does not necessarily preclude the provision of budget support. But fiduciary risk must be thoroughly evaluated and clearly presented.

19. The risk is perceived as the measure of uncertainty as to whether these fiduciary requirements are actually met, and as the combination of both likelihood and impact. Materiality of any deficiencies is thus an issue – what impact will individual PFM deficiencies have the overall quality of the PFM system.
20. The DFID definition of fiduciary risk is thus wider than that of the World Bank, specifically in the second point. While the DFID PFM assessment is not a direct or substantive assessment of whether value for money (meaning pro-poorness) of expenditures (and revenues) is achieved, its 12 Good Practice Principles and related 15 PFM benchmarks include the extent to which the budget supports pro-poor strategies ¹⁷. Thus the DFID approach analyzes the operation of the PFM system in terms of its pro-poor focus i.e. does the PFM *system* provide for an adequate focus on poverty reduction. However it does not involve any *substantive* analysis of the pro-poorness of budget expenditures.

OTHER RISK CONCEPTS AND THEIR RELATIONSHIP WITH FIDUCIARY RISK

21. Fiduciary risk is regarded as separate from *sovereign financial risk* – the risk that donor assistance which is provided by way a loan will not be re-paid. This is a lending risk, but is assessed differently through fiscal sustainability analysis and other tools. It is also managed through different mechanisms.
22. Another risk identified in all modalities of assistance is *development risk* – that the assistance will not achieve its development objectives of economic growth and poverty reduction. This key risk is a wider concept than fiduciary risk. Poor PFM systems will increase development risk. In this sense fiduciary risk can be seen as one component of development risk. But development risk is assessed differently, through a broader results measurement approach. However the DFID definition of fiduciary risk, specifically the component “whether the expenditure is likely to

¹⁷ These Good Practice Principles and Benchmarks are to be used, pending agreement between donors and partner countries on a common set of PFM performance indicators. See paragraphs 43 - 46 below.

achieve value-for-money, (that is result in poverty-reduction) is partly a development risk issue.

23. *Reputational* risk also arises in all modalities of financial support. This is the risk of perceptions, real or otherwise, of poor management of funds including corruption. While this is also often perceived as a donor issue, resulting in political costs to donors which may affect their ability to continue budget support, it is also relevant to partner country governments in their accountability to their own citizens for the management of public finances. Reputational risk thus imposes costs or limitations both on donors and partner countries. Mitigating reputational risk is often the reason for some risk mitigation strategies required by donors in budget support, as discussed later.

PROCUREMENT ISSUES IN FIDUCIARY RISK

24. The functioning of the public procurement system is obviously important in all the possible components of fiduciary risk discussed above, given that in many partner countries a high proportion of budget expenditures flow through the public procurement system. The procurement system, in this sense, is thus an inherent part of the PFM system. But in practice procurement operates as a professional activity somewhat separate from the rest of the PFM system. Different professional groups within donor countries and donor institutions manage the diagnostic or analytical work on country procurement systems – including developmental work to improve country procurement systems. Likewise international work on donor and country harmonization and alignment has seen separate working groups covering PFM and procurement.¹⁸
25. The World Bank has a separate diagnostic tool for public procurement systems, the Country Procurement Assessment Report (CPAR)¹⁹. A CPAR is designed to provide a comprehensive analysis of a country's public procurement system, assess institutional, organizational and other risks associated with procurement, to develop a prioritized plan for institutional improvements and to assess the competitiveness and performance of the country's private sector in its involvement in public procurement, and the adequacy of commercial practices related to public procurement. In the past its main focus has been on the assessing the acceptability of country public procurement systems for use in Bank financed investment projects and its risk discussion is till largely in terms of these projects. However its role in feeding into budget support operations is now also recognized, both in terms of developmental and fiduciary issues.

¹⁸ This is well illustrated by the separate OECD/DAC Joint Venture on Public Financial Management and the OECD/DAC Procurement Roundtable.

¹⁹ Revised CPAR Procedures, World Bank, April 2002

- 26.** The CPAR Procedures discuss fiduciary risk issues in some detail. A central tenet of the CPAR is the evaluation of different risks associated with the country's procurement system. The risks to be managed are listed as risks of
- loss of economy and efficiency in procurement (this is outside the scope of fiduciary risk, as defined in the CFAA Guidelines – see paragraph 16 above)
 - exclusion of certain eligible bidders from competing for bids
 - unfair and inequitable treatment of suppliers and contractors
 - lack of integrity, fairness and public confidence in the procurement system
- 27.** The procedures require a risk assessment, indicating whether the procurement risks are high, medium or low. However no guidance is provided on determining how to assess the level of risk. In addition, in most CPARs there has been no explicit discussion of these risk issues in relation to budget support operations; rather it is implicit in the analysis and discussion in the report.
- 28.** Other donor PFM diagnostic work includes procurement issues. The DFID Guidelines include one Good Practice Principle on procurement –that procurement is carried out in line with principles of value for money, covering two benchmarks on procurement issues, which feeds into its overall risk assessment. The HIPC tracking indicators have recently been expanded to include a benchmark on effective procurement, which is described as promoting competition, transparency and value for money in procurement. But as previously mentioned this is not part of an explicit risk assessment.
- 29.** The PFM performance measurement framework now being finalized by the Public Expenditure Working Group (World Bank, IMF and PEFA) see paragraphs 43-46 below) incorporates a measures of the performance of the procurement system. In addition the Bank has been developing more detailed indicators to evaluate a country's public procurement system, as part a move to pilot the increased use of country systems in Bank financed investment opeations.
- 30.** Thus procurement issues are identified as part of the information base to be used in assessing fiduciary risk, but no methodology has yet been developed for making an explicit assessment of fiduciary risk.

CORRUPTION ISSUES IN FIDUCIARY RISK

31. Corruption issues go much wider than the PFM and procurement systems. But clearly, official corruption will affect the functioning of the PFM and procurement systems – whether through diversion of funds or whatever, and affect the level of fiduciary risk. Both the CFAA Guidelines and the DFID guidance mention the need for anti-corruption diagnostic information to be used in decisions on budget support operations. The CFAA Guidelines mention focusing on aspects of the PFM system which may be most likely to facilitate corruption- such as non transparent off-budget accounts or failure to observe internal controls. DFID requires an explicit statement on corruption information as part of the information base for decisions on budget support operations, although it does not require any explicit corruption risk rating.
32. The Bank’s revised CPAR Procedures also address corruption issues, through requiring a review of the basis of transparency and accountability in the procurement system. Issues examined include the existence or otherwise of a code of ethics for government employees, adequacy of procedures for reporting bribes, adequacy of access to administrative review and appeal and other measures and initiatives to curb or control corruption, including legislation.

FLOW OF FUNDS ISSUES

33. The risk that donor funds for budget support might not reach the budget is discussed extensively in World Bank Good Practice guidance on Development Policy Lending²⁰. Donors provide foreign exchange to the partner country’s central bank, which is generally converted into local currency and credited to an account of the government held at the central bank which forms part of budget funds. It is not possible to trace the ultimate use of the foreign exchange, given the fungibility of the country’s foreign exchange reserves. Indeed the Bank does not seek to assess the appropriateness of the use of the foreign exchange; this is perceived in any case as an IMF issue. Rather the Bank’s approach is to review the control environment within which the foreign exchange is managed by the country, based on the IMF safeguards assessments of central banks. Where this indicates potential weaknesses, or where there is inadequate information several risk mitigation strategies are available. These may include deposit of the Bank’s loan proceeds into a dedicated account at the central bank used exclusively for this operation, with the possibility also of an audit of the dedicated account to ensure that the amount has been correctly transferred to a government account which forms part of the budget and/or that payments from such an account were (or were not) made for specified purposes.

USING THE PFM DIAGNOSTIC INFORMATION

²⁰ Financial Management Issues in Development Policy Lending , Good Practice Note No.3. Good Practice Notes in Development Policy lending , Operations Policy and Country Services, October 2004

- 34.** Different donors will have different thresholds for the level of fiduciary risk they are prepared to accept in order to undertake budget support. Some may wish to set minimum PFM and procurement standards. Others may prefer to focus on commitment to and occurrence of improvements in PFM and procurement systems, that is the trajectory of change. But it now seems generally agreed that all should draw from the same information base on the PFM system, developed collaboratively between donors with partner country participation and ownership to the greatest extent possible ²¹.
- 35.** The World Bank's general approach to the use of PFM diagnostic information has been articulated as follows ²²
- no minimum PFM standard has been established as a pre-condition for budget support
 - budget support may be provided in a country with weak PFM where there is government commitment to an adequate PFM reform plan, and there is reasonable evidence that improvements are occurring in a timely manner
 - thus improved PFM may be an outcome, rather than a precondition for budget support
- 36.** The diagnostic information feeds into Bank decisions about the amount of individual budget support operations, tranching, program content, conditionality and risk mitigation measures. Other donors might also address these issues, in which case the Bank need not duplicate them in its budget support operation. Thus, in terms of decision making, recommendations that may arise from the risk assessment might include the following for a proposed budget support operation
- integrating more fully into the operation actions to deal with known PFM weaknesses
 - where adequate information on the operation of the PFM system is not yet available, delaying the operation until adequate information is available
 - reducing the size of the operation

²¹ See Harmonizing Donor Practices for Effective Aid Delivery, Good Practice Papers, Chapter 3, Measuring Performance in Public Financial Management, DAC Guidelines and Reference Series, OECD 2003 and World Bank – Assessing and Reforming Public Financial Management, A New Approach. Richard Allen, Salvatore Schiavo-Campo, Thomas Columkill Garity, 2004. Both these documents discuss the need for donor collaboration to reduce the number of separate PFM diagnostics, both to improve the quality of diagnostic work and to reduce transaction costs to donors and partner countries.

²² Financial Management Issues in Development Policy Lending , Good Practice Note No.3. Good Practice Notes in Development Policy lending , Operations Policy and Country Services, October 2004

- having a programmatic operation, to “ratchet up” any PFM conditions at each successive stage
- not proceeding with the operation

37. A further possible decision is when to withdraw budget support, because of increased fiduciary concerns. This is a conditionality design issue. It seems generally agreed that such conditions should be clear and the circumstances under which budget support might be withdrawn should be transparent and understood by all parties. For example, the UK National Audit Office has noted this issue²³ and suggested that DFID should develop criteria for this and early warning indicators.

MEASURING AND CALIBRATING THE RISK

38. The generally accepted view is that assessing fiduciary risk necessarily involves judgments, rather than apparently finely calibrated risk measurements. And the judgment is country specific. Different approaches can be observed to giving an overall summary of quantification of the level of fiduciary risk.

39. The World Bank’s CFAA Guidelines²⁴ suggest that the overall assessment should focus on a few key factors and should be a relatively brief summary of the reasons behind the overall assessment – which is to be assessed on a four part scale – low, medium, significant and high. Detailed guidance on deciding which classification is appropriate is not provided. A recent review by the Bank²⁵ found considerable variations in approach to the risk assessment. It is worth noting also that of the 31 CFAAs or equivalent reviewed, financial management risk was assessed as high in 13 countries, significant in 8, moderate in 3 and low in only one country. Six of the CFAAs contained no explicit risk assessment.

40. The DFID guidance²⁶ provides for a risk rating using a three part scale

- low risk, where there is basic compliance i.e. no significant weaknesses,
- medium risk - some significant weaknesses and
- high risk - substantial failure to comply,

for each of its 15 PFM benchmarks, applied “on a conservative basis”. Because of the perceived complexity these ratings are not perceived as “an exact science” and

²³ Department for International Development, A review of Safeguards Against the Misappropriation and Diversion of Aid. National Audit Office 2002

²⁴ Country Financial Accountability Assessments Guidelines to Staff, World Bank, Financial Management Sector Board, May 27 2003

²⁵ Evaluating Financial Management Risk in Country Financial Management Accountability Assessments, Financial Management Anchor, 2004

²⁶ Ibid , paragraphs 58-63

like the CFAA Guidelines no explicit criteria is set out for the three ratings. To supplement these ratings a “trajectory of change” (is the situation improving or not) is included for each benchmark.

41. The DFID guidance provides for an overall rating for fiduciary risk to be developed using the high/medium/low scale, but again no specific guidance on how to determine the overall rating is provided. However the risk assessment is supplemented by a statement on risks of corruption (as mentioned in paragraph 31) and information on PFM reform plans and improvements. Thus assessing country commitment to PFM and Procurement reform, supplements the formal risk assessment for decisions on financial assistance.
42. The HIPC Expenditure Tracking Assessment, while not a formal fiduciary risk assessment, uses 16 benchmarks in assessing the overall quality of the PFM system. It calibrates countries on the basis of PFM systems needing little upgrading (meeting at least 11 of the 16 benchmarks), needing some upgrading (meeting 8 to 10 of the benchmarks) and needing substantial upgrading (meeting 7 or fewer of the benchmarks). Meeting these benchmarks or a certain number of key ones could be used as a minimum standard if a donor wished to use the information in this way.
43. Recent work by the Public Expenditure Working Group (PEFA, the World Bank and IMF) has focused on developing a comprehensive PFM performance measurement framework,²⁷ consistent with the overall move to a greater results focus in development operations and to developing a harmonized approach which is broadly acceptable to all donors and partner countries. Building on the HIPC indicators, some 28 indicators (including procurement) have been developed, and a proposed system of calibration for each indicator developed. The indicators have been tested in a number of countries in terms of clarity of definition and discussed at a workshop organized by PEFA for country officials in the Africa region. In general they have been well accepted as relevant and useful.
44. However there is as yet no clear consensus on the calibration and “scoring” mechanism which might be applied to such indicators. In particular discussions are still underway on the issue of how or whether to summarize this into an overall measurement of the quality of the PFM system – and whether it should be narrative or numerical or otherwise quantitative. If numbers are attached to individual indicators there may be a tendency to add them up, with or without some explicit weighting of each indicator, and to play a complex but ultimately subjective numbers game – possibly encouraging a minimum PFM standards approach.
45. There is also concern from some countries, particularly from middle income countries which have access to private capital markets, about the PFM performance measurement framework becoming a de-facto rating system, with comparisons being made between the “scores” of individual countries. This partly reflects

²⁷ Now published - PEFA Secretariat, World Bank , Public Financial Management, Performance Measurement Framework June 2005

concerns about the need to recognize differences in the country circumstances which would affect the relative importance of individual indicators, and the necessarily subjective nature of some of the judgments. The risks of possible misuse (or perhaps “overuse”) of such performance information are lessened if the focus is on improvements within a country over time -which is intended to be the focus: that is, is the country’s PFM system improving ?

46. There also appear to be some concerns about possible complexity and over-engineering of the performance measurement framework, and whether the situation conveyed is sufficiently dynamic, recognizing the change trajectory, rather than absolute positions.
47. An overall measure of the quality of the PFM system, given the principle that the best fiduciary assurance comes from a well performing PFM system, is clearly closely linked with the overall fiduciary risk assessment. However it differs, not only because it excludes the funds flow component of the fiduciary risk (see paragraph 33 above) but because it may not focus explicitly on key fiduciary risk areas, which may vary between countries. For example the DFID guidance refers to the need to identify key or priority areas of risk. For example if a substantial proportion of budget spending relates to the civil service payroll, or to public procurement, greater attention should be paid to the payroll and public procurement systems. It also identifies large transfers to state owned enterprises, significant decentralization of resources to sub-national governments and major sources of revenue such as oil revenues, as potential high risk areas, for more detailed attention. The Bank’s CFAA Guidelines also note extra-budgetary funds with little or no transparency concerning their operations as another likely key area of risk, and as an issue this is likely to differ significantly between countries.

STRATEGIES TO MANAGE AND MITIGATE FIDUCIARY RISK

PFM Improvement Plans – the Longer-Term View

48. Reflecting the discussion in paragraph 2 above, the key medium to long-term strategy to mitigate fiduciary risk is to work with the country to have it lead a comprehensive PFM and Procurement reform agenda, with donors providing coordinated technical assistance as necessary - the development side of the PFM coin. Thus actions also on the part of the partner country (reflecting mutual accountability) are important in mitigating fiduciary risk
49. There is now a considerable body of experience with partner country PFM and procurement reform action plans, not all of which is good. Problems which have been identified include an overloaded reform agenda - both too many separate action plans and too many individual components, reforms which are inappropriate given the country’s level of capacity, donor competition rather than collaboration on technical assistance and lack of country ownership. Many of these experiences have been distilled into recently issued good practice notes on PFM and

procurement capacity development. Experience also suggests²⁸ that PFM improvement requires time, and different components need appropriate sequencing.

50. A study commissioned by PEFA in 2003 which reviewed practices across 17 multilateral and bilateral agencies, outlines a “platform” approach to a PFM reform program²⁹, to address the perceived problem of diverse and uncoordinated and unrealistic donor reform plans and requirements – some of which may originate from donor conditions for providing financial assistance. The study suggests identifying various platforms of key requirements, on which subsequent reforms may build, in effect providing the building block for a sequenced reform program.

51. The DFID guidance³⁰ discusses in some detail the need for a credible program to improve PFM and what its components might be. Desirably it should be

- government led, realistic and achievable,
- contain a comprehensive framework which is effectively sequenced,
- relevant and sustainable,
- focus on developing local capacity,
- build demand for change and
- include specific performance indicators.

52. To this could be added the need to assess real government ownership. This may be reflected by

- a good track record in implementing reforms, particularly in areas which might be particularly difficult, either technically or politically
- the government having initiated reform proposals
- publicly stated political support for reforms
- the government taking the lead role in coordinating the technical assistance of a range of donors

²⁸ See for example good practice notes on capacity development in procurement, issued by OECD/DAC Roundtable on Procurement 2004, and Capacity Development in Public Financial Management, Chapter 4 of Harmonising Donor Practices for Effective Aid Delivery, DAC Guidelines and Reference Series,

²⁹ Study of Measures Used to Address Weaknesses in Public Financial Management Systems in the Context of Policy based Support, PEFA, Peter Brooks, Bannock Consulting, April 2003

³⁰ Managing Fiduciary Risk When Providing Direct Budget Support (How To note and Briefing, 22 September, 2004) Department for International Development

Audit and other shorter term approaches

53. Some shorter-term measures may be used by certain donors, to mitigate fiduciary risk. The PEFA study³¹ identifies 60 to 70 different approaches adopted by a range of donors, some of them being part of conditions for budget support, and some suggested or required by donor national audit institutions. These include

- “deeming” or earmarking of budget support to particular purposes. For example under a previous DFID approach budget support funds were linked to certain budget line items so as to protect these expenditure items – civil service salaries (sometimes targeted more specifically to salaries of teachers or health workers), other designated “pro-poor” expenditures, repayment of debt etc, with in some cases a requirement for an audit undertaken by an external party to verify that the relevant expenditures had been incurred. A variation of this approach involves the creation of separate “poverty funds” within the budget into which donor assistance is paid. While this may be important to sustaining political support for budget support and reducing reputational risk, their real impact is limited, particularly given fungibility of budget resources. Indeed, the 2003 PEFA study suggests that such short-term safeguards are often fragmented and ineffective in providing substantive fiduciary assurance. While recognizing the fiduciary concerns of donors it suggests that these cannot be solved immediately and that implicit acceptance of a degree of risk is necessary (see discussion in paragraph 4 above).

- adopting a “negative list” concept, under which budget support funds are (somehow) divorced from perceived non “pro-poor” expenditures such as internal security or defence undertaken through the budget. The World Bank maintains such a “negative list” in its new DPL lending policy, although clearly fungibility of budget resources makes it problematical to implement this. However such a list has a role in mitigating reputational risk. A review of the operation of the negative list by the Bank indicated that “it has been very difficult to track the use of adjustment loan proceeds beyond the initial receipt of funds”³². Thus the inherent contradiction between a negative list and fungibility was not addressed in the Bank’s new DPL policy. However the previous option of an attestation of non expenditure on ineligible items in any audit of the deposit account was removed.

- undertaking Public Expenditure Tracking Surveys (PETS) which analyze the extent to which budgeted funds actually reach the intended point of local service

³¹ Study of Measures Used to Address Weaknesses in Public Financial Management Systems in the Context of Policy based Support, PEFA, Peter Brooks, Bannock Consulting, April 2003

³² The discussion continues “One option would be to recognize this reality and simply eliminate the requirement for a negative list. This may however expose the bank to reputational risks.... The preferred option is therefore to retain the borrower’s undertaking in the legal agreement that it will not use adjustment loan proceeds to finance items on the negative list. This option should however be based on a clear understanding of the limits in monitoring and enforcing such a requirement. Basically such an undertaking would serve as a self-implementing “code of conduct...” (From *Adjustment Lending to Development Policy lending*, *Update of World Bank Policy*, Operations Policy and Country Services, August 2004, p 29.)

delivery as opposed to being diverted, either properly or improperly, for other purposes. (Evidence suggests a dramatic improvement in the rate of budget execution at the local level when the budget allocations for local service delivery units are made public.) But PETS also have other objectives, such as improving service delivery arrangements.

- requirements to implement specific controls or new legislation, to meet specific concerns of individual donors and capacity enhancement requirements, to address a specific deficiency of concern to the particular donor. Both of these may contribute to the problem of uncoordinated and unrealistic PFM improvement plans discussed in paragraphs 48-49 above.

- requirement for timely audited aggregate financial statements (focusing on budget execution) from the partner country as a condition of budget support. This would address the risk component of not knowing how the budget support was spent. As mentioned in footnote 9 above, in practice few partner countries are even as of now able to provide such statements. A 2000 proposal that such a requirement be part of World Bank policy for budget support was rejected by the Bank's board of directors, apparently because it was perceived as unnecessarily intrusive.

54. The PEFA study reaches a number of important conclusions, including

- donors increasingly recognize the need to move away from short-term and fragmented approaches, to focus on longer-term developmental objectives through government led reform PFM programs

- however there is still a pattern of fragmented and partial measures, with little coordination between donors and even within individual donors, which may undermine the development of realistically sequenced PFM reform programs

The European Commission approach

55. EC has previously required ex post audits of its budget support operations, although the focus is now changing. These audits, carried out by a firm contracted by the EC assessed the country PFM system. They focused on the legality and regularity of expenditures, in terms of the agreement between the EC and the country concerned. In the cases of "targeted" budget support, which sought to protect social expenditures, EC funds were paid into a separate account with the EC and the country authorities as dual signatories. Audits reviewed the extent to which the EC funds were managed in accordance with the country's budget rules and procedures. To the extent to which funds covered in the audit sample were not spent in accordance with the agreement or managed in accordance with the country's own systems, the assistance would have to be repaid, or at least treated as an advance against subsequent assistance.

56. This system often involved significant transactions costs and delays. The EC has now moved to place greater emphasis on ex ante assessments of the overall PFM

system, working in collaboration with other donors³³ - for example, it has been a major participant in the PEFA program. This assessment is intended to be complemented by a compliance test, to provide empirical evidence of the functioning of the PFM system and in some cases the quality of public expenditures.

THE INFLUENCE OF DONOR OVERSIGHT INSTITUTIONS

- 57.** It appears to be generally accepted that fiduciary issues should be clearly explained to and discussed with donor legislatures and external audit institutions, in order to develop and maintain political support for budget support. The PEFA review (paragraph 50 above) refers to short-term measures, some of which have been suggested or required by donor national audit institutions.
- 58.** Because of the perceived riskiness of budget support, the European Parliament and the EU Court of Auditors appear to have taken a strong interest in the EC's budget support operations as indicated by a number of special reports³⁴ and to have influenced the EC's approach to fiduciary issues, as discussed in paragraphs 55 – 56 above. In some cases it appears that special audits have been undertaken at the request of the Parliament.
- 59.** The UK National Audit Office has closely reviewed DFID's approach to fiduciary risk management in budget support. Its special report on this issue³⁵ commends DFID for the publication of its March 2003 paper on *Managing Fiduciary Risk When Providing Direct Budget Support*, and indicates the NAO's willingness to contribute to DFID's work in developing its approach to mitigating fiduciary risk.

Is Budget Support Improving PFM ?

- 60.** The first question to be asked is whether country PFM systems are improving. While determining this is not a clear-cut exercise, attributing this to budget support operations is even more difficult. The discussion below therefore represents a tentative approach to this issue.

Is PFM Improving in Partner Countries ?

- 61.** The most systematic review of improvements in PFM across a range of countries appears to be the updates on the assessments and implementation of action plans

³³ See EC, Guide to Programming and Implementation of Budget Support for Third Countries, March 2003

³⁴ For example Special Report on the Use of Counterpart Funds from Structural Adjustment Support Earmarked for Budget Aid, Report 2001 on Budget Support

³⁵ Department for International development, A review of Safeguards Against the Misappropriation and Diversion of Aid. National Audit Office 2002

under the HIPC expenditure tracking exercise. The most recent review³⁶ of changes since the previous review in March 2002, across 24 HIPC countries shows a mixed picture of performance across countries and the indicators, but with some improvement overall. However substantial improvement is still required. Budget reporting showed the largest improvement, but performance under budget formulation and execution was more limited or marginal. But overall the average number of benchmarks met per country rose slightly. The review also indicates progress since 2002 in implementing the action plans. It appears that well targeted action plans, with partner country commitment and coordinated donor systems are effective in improving PFM performance.

- 62.** Procurement systems in HIPCs were found to be weak, with no country meeting the new procurement benchmark. However as a new indicator, there were no prior year's ratings on which to judge whether improvement is occurring.
- 63.** The HIPC indicators have also been applied in a number of non-HIPC countries, but there has been no follow up reviews in these cases to indicate whether improvements are occurring.
- 64.** Apart from this, the World Bank's annual Country Policy and Institutional Assessment (CPIA) exercise measures quality of budgetary and financial management as one of 20 components in an overall assessment of country performance, which is used in determining the allocation of funds under IDA. The 2004 CPIA preliminary assessments, which cover over 130 client countries indicate improvement in 40 countries, deterioration in 14 and no change in the rest. While final ratings are likely to be somewhat scaled back, overall there is indication of PFM progress.
- 65.** The need to measure whether PFM performance is improving in individual countries is reflected in the work of the Public Expenditure Working Group on developing the performance management framework as discussed in paragraphs 43-46 above. In addition there is now a need to look further across a "universe of countries." The Declaration from the Paris High Level Forum on Harmonization, Alignment, Results and Mutual Accountability³⁷ commits the donor and partner country community to a series of indicators of progress, which include "increases in the number of partner countries that have procurement and public financial management systems that either (a) adhere to broadly accepted good practices or (b) have a reform program in place to achieve these. A target for this indicator is required to be set by September, 2005. However to do this a baseline will need to be established. It is unclear as yet how this baseline might be established or how meeting "broadly accepted good practices" will be defined.

³⁶ Update on the Assessment and Implementation of Actions Plans to Strengthen Capacity of HIPCs to Track Poverty Reducing Public Spending, IMF and World Bank, April 12 2005

³⁷ Paris Declaration on Aid Effectiveness, Ownership, Harmonization, Alignment, Results and Mutual Accountability, p 9, Part III Indicators of Progress

The Impact of Budget Support Operations

66. Improvements in PFM and procurement systems are sought through conditions and benchmarks in budget support operations and associated capacity development activities. Recent reviews of such World Bank conditionality³⁸, feeding into the new policy on budget support, have suggested

- conditionality cannot be a substitute for country ownership
- conditionality needs to be used more selectively, tailored to country circumstances
- a move to ex post rather than ex ante conditionality is desirable (reflecting greater reliance on programmatic operations)

These comments apply also to PFM and procurement conditions and benchmarks. Good Practice Guidance now provided on the design of budget support operations suggest³⁹

- select a limited number of conditions and triggers (which should be controllable by the country)
- be more liberal in the number of benchmarks (milestones, which are not legally binding)
- benchmarks should become more outcome focused as the program progresses and may be appropriately modified as the program progresses

67. Overall, in the Bank's budget support operations, PFM and procurement related conditions and benchmarks accounted for some 14 percent of total conditions and benchmarks over the period 2001 to 2005, ranging from 10 percent in 2005 to 17 percent in 2004.

68. The Bank's Poverty Reduction Support Credits (PRSCs) are appropriate for separate review because of their programmatic nature, involving the phasing of reforms over a period of years as part of a medium term reform program, rather than one off measures. Programmatic PFM related benchmarks have covered a range of issues including budget preparation, budget execution, accounting and reporting, auditing and external oversight. PFM-related conditions include legal conditions of effectiveness, prior actions, conditions for presentation to the Board, and conditions for release of tranches. PFM-related conditions and policy actions were 19 percent of all conditions in FY01-04 PRSCs, and increased every year in

³⁸ see for example S. Koeberle , Should Policy Based Lending Still Involve Conditionality World Bank Research Observer, Fall 2003

³⁹ Good Practice Notes for Development Policy Lending, Good Practice Note 1 – Designing Development Policy Operations, OPCS October 2004

the period. In FY01, PFM-related conditions were 9 percent, and this increased to 21 percent in FY04. In addition to conditions, PRSCs also included policy actions that are not legally binding but that were included in the policy matrix as actions agreed by governments with the Bank. Out of the 937 policy actions agreed by governments in these PRSCs, 182 were related to PFM and 41 were related to procurement

- 69.** Some of these conditions and benchmarks have been legal or regulatory such as the passing of laws or regulations. Others have been more institutional such as improvement in information systems, the introduction of Medium Term Expenditure Frameworks (MTEF) and new budget classifications. However it is now generally accepted that, as with many other conditions and benchmarks, they have been overly process oriented and insufficiently results oriented. However it can be argued that process measures are appropriate at earlier stages of operations, with results measures are factored into later stages when results should be expected to emerge.
- 70.** While it is still premature to judge the extent to which PRSCs are contributing to improvements in PFM and procurement systems for those countries now having had several phases of their PRSCs some tentative observations can be made. The HIPC Expenditure Tracking assessment indicates the following changes for countries having multi-year PRSCs from the 2002 to the 2005 reports (based on assessments done in 2001 the original 15 benchmarks and assessments done in 2004 using the 16 benchmarks)

Total benchmarks met	2001	2004
Burkina Faso	8	9
Ethiopia	6	7
Ghana	1	7
Tanzania	8	11
Uganda	9	8

The apparent deterioration in Uganda is interesting and needs to be further analyzed.

- 71.** Improvements through PRSCs can also be noted through the legally binding conditions which have been required to be met at each phase of the PRSC. These have focused mainly on process issues such as passing legislation, completion of reports, publication of data etc. Desirably such conditions are based on a clear assessment of what key PFM performance improvements will result from them in the medium term, but this may not always have been the case. There has been heavy emphasis in PRSC conditions on budget preparation issues, and to a lesser extent on accounting, reporting and audit issues, and arguably insufficient emphasis on budget execution issues.

FURTHER READING

World Bank - OP 8.60, Development Policy Lending 2004

World Bank - Financial Management Issues in Development Policy Lending ; Good Practice Note No 3, Good Practice Notes for Development Policy Lending, Operations Policy and Country Services, October 2004

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Crown Agents (2002) – Donor Accountability Study (“on behalf of seven like minded donors”)

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OECD 2003 and 2005 , Harmonising Donor Practices for Effective Aid Delivery, DAC Guidelines and Reference Series, Good Practice Papers Chapter 3; and Volume 2, Budget Support, Sector Wide Approaches and Capacity development in Public Financial Management. Chapter 4, Capacity Development in Public Financial Management

PEFA Secretariat, World Bank. Public Financial Management, Performance Measurement Framework, June 2005