



# WHAT ARE THE BENEFITS OF USING COUNTRY SYSTEMS?

Policy Brief 1

## Benefits of using country PFM systems

### Policy brief 1: Aid effectiveness community

The aid effectiveness commitments agreed upon in Rome, Paris and Accra call for an increase in the use of partner country systems, in particular the national budget and Public Financial Management (PFM) systems (see Box 1 below).

Since 2005, however, there has been only modest progress: less than half of aid to the Government Sector uses recipient country PFM systems.<sup>1</sup> Overall, improvements mainly reflect increased provision of budget support in some countries. Progress on other aid modalities, in particular projects, remains limited. Strengthening of recipient country PFM systems has not led to proportional increases in their use by donors.

#### BOX 1: PARIS AND ACCRA COMMITMENTS ON USING PARTNER COUNTRY SYSTEMS

*Paris Declaration Commitments:* Donors commit to... use country systems and procedures to the maximum extent possible. Where use of country systems is not feasible, establish additional safeguards and measures in ways that strengthen rather than undermine country systems and procedures.

*Accra Agenda for Action:* Donors agree to use country systems as the first option for aid programmes in support of activities managed by the public sector... Should donors choose to use another option and rely on aid delivery mechanisms outside country systems (including parallel project implementation units), they will transparently state the rationale for this and will review their positions at regular intervals. Where use of country systems is not feasible, donors will establish additional safeguards and measures in ways that strengthen rather than undermine country systems and procedures... donors will aim to channel 50% or more of government-to-government assistance through country fiduciary systems, including by increasing the percentage of assistance provided through programme-based approaches.

This briefing outlines:

- the benefits both for donors and for recipient countries of increasing the use of partner country PFM systems;
- what using partner country systems means in practice; and
- what donors and partner countries can do to accelerate progress.

### What benefits can be expected from the use of country PFM systems?

Governments have a crucial role in providing services for poverty reduction and economic development. Effective services require good public financial management in developed and developing countries alike.

Where government systems are weak, donors have tended not to use them but to set up parallel systems. This creates duplication and increases transaction costs, hampers alignment with country priorities and ownership, and constrains efforts to strengthen national capacity.<sup>2</sup>

1. The Paris Declaration surveys (2006 and 2008) provide the most comprehensive and only quantified cross-country and cross-donor measurement on the use of country systems (indicator 5a – budget execution, auditing and financial reporting, and indicator 5b – procurement). They indicate a slight increase between 2005 and 2007, from 39% to 45% of ODA to the government sector using recipient country PFM systems. The use of procurement systems has increased from 40% to 43%. These figures nevertheless hide significant disparities between countries and donors.

2. See for example, Dollar, D and L. Pritchett (1998).

Conversely, aid that uses recipient country systems can provide incentives and momentum to strengthen national capacity and performance:

- It can shift both donors' and recipient governments' focus towards strengthening the recipient country's own systems instead of developing parallel ones. This is expected to reduce partner countries' transaction costs in managing aid, and to lead to more sustainable improvements in the long term.
- It can also help to establish widely accepted good PFM practices (comprehensiveness, transparency, accountability) in recipient countries.<sup>3</sup> This is expected to make their management of all public resources, including aid, more efficient.
- Finally, ensuring the national budget and public accounts are more transparent and comprehensive, by including all relevant information on aid, can strengthen the domestic accountabilities between the Ministry of Finance, line ministries, Parliament, the Supreme Audit Institution, and citizens.

Thus, a major benefit of using recipient country PFM systems is to avoid the harm caused by using parallel systems, and to contribute to sustainable development outcomes at country level.

Donors' use of country systems needs pro-active support because its benefits are generally long-term and diffuse, and sometimes difficult to quantify, while the perceived risks are short term and specific to the agency concerned.

### **What is the minimum quality of partner country PFM systems required for these benefits to materialise?**

Partner country PFM systems that are already strong can bring about additional benefits, and reduce the fiduciary risk for donors. However, experience shows that there is no minimum threshold for the benefits of using partner country PFM systems to materialise, as long as partner governments are clearly committed to improving the quality of these systems. The Use of Country Systems is not an 'all or nothing' approach and gradual increases in the use of country systems will also yield significant benefits.

Immediate benefits relate to the transition from using parallel systems to using the mainstream domestic PFM systems, thereby avoiding the harms associated with bypassing government systems. The scale of benefits therefore depend on how this transition is implemented: what share of aid uses country systems, how predictable it is, the extent to which mainstream country systems are modified by special donor requirements, etc.

### **Is there any evidence of such benefits materialising in practice?**

Studies have found concrete benefits – both for donors and for partner governments – from the shift to using country PFM systems, whether in their entirety or through specific components:

- *Better PFM practices*: improved transparency and comprehensiveness of the budget and accounts can lead to more efficient allocations and better fiscal discipline. Box 2 illustrates how a recipient government was able to better balance recurrent and investment expenditure, while there was increased focus on improving national PFM processes including at decentralised and service delivery levels.

#### **BOX 2: BALANCING RECURRENT AND INVESTMENT EXPENDITURES IN RWANDA**

The donor shift from projects to the sector budget support aid modality has helped rebalance the recurrent/investment composition of the education budget. In particular, it has allowed consideration of the recurrent implications of investment expenditures, in a way that project aid did not support as much in the past... A concrete example was given by the Director of Construction in MINEDUC [the Ministry of Education], whereby the increase in Sector Budget Support (SBS) has enabled MINEDUC to provide schools with transfers for school maintenance (through the capitation grant), which did not happen in the past despite significant amounts being spent through projects on school construction. Although he recognised that further efforts are required to increase maintenance expenditure and provide further guidance to schools, the Director felt that this was a very significant and positive outcome of donors' shift to SBS.

... With the strong increase in amounts transferred directly from central government to schools, in particular with the significant increase in the capitation grant, more pressure has been put on improving the management of funds at school level by SBS donors in the dialogue.

Source: Mokoro & ODI (2009), para. 163 and p. 44.

3. See International Public Sector Accounting Standards; IMF Fiscal Transparency code; PEFA framework; World Bank's Public Expenditure Management Handbook.

Box 3 highlights the positive impact of budget transparency and comprehensiveness on fiscal performance as analysed by a recent IMF study. Its findings underline the potential positive effects of a more comprehensive and transparent reflection of aid in the partner country budget documentation.

### **BOX 3: LINKS BETWEEN BUDGET COMPREHENSIVENESS AND TRANSPARENCY AND FISCAL DISCIPLINE**

A recent IMF working paper (IMF 2010) presents an empirical analysis of the link between strong budget institutions and good fiscal performance in low-income countries.

The study provides “preliminary evidence that countries with sound budget institutions promote fiscal discipline, as measured by higher primary balances and lower debt, and are relevant for shaping less procyclical responses to the fiscal cycle in low-income countries, including during the current crisis” (p. 26). In particular, it concludes that “one clear result is that more comprehensive and transparent budget processes have the most pronounced influence on both primary balances” (p. 21), and that “the most significant institutions are those related to planning and implementing the budget, and to the sustainability, comprehensiveness and transparency of the budget process” (p. 26).

Finally, the study further highlights the crucial importance of budget transparency in contributing to improved budget processes and outcomes: “the fact that a more transparent and comprehensive budget seems to matter more than rules and top-down procedures may indicate that, for low-income countries, budget procedures that facilitate external monitoring are more credible mechanisms for ensuring proper fiscal responses than procedures that facilitate government self-monitoring.” (p. 27).

- *Lower transaction costs for partner countries:* these relate to enhanced cash management (leading to potentially significant savings); higher budget execution rates; improved predictability of transfers to lower levels; and reduced transaction costs regarding procurement especially for local companies. An illustration is provided by a recent World Bank study which examined eight different financing modalities supporting rural water supply in Ethiopia. Its conclusions are outlined in Box 4.

### **BOX 4: WORLD BANK ANALYSIS OF WATER SECTOR IN ETHIOPIA**

Annual utilisation rates varied widely across financing modalities, from 27 percent to 100 percent. Modalities with low utilisation rates set up parallel procedures that centralised control of decentralised service delivery – particularly accounting, but also procurement. Based on the experience that regional and woreda [district] staff have of working with the various financing modalities, the evidence is that the parallel accounting mechanisms set up by centrally-financed initiatives ... are a significant and often disruptive brake on implementation...

While for procurement there is still a case to keep some streamlined and simplified control measures in place, the parallel accounting systems being set up by centrally-financed initiatives are inferior to the core integrated budget and expenditure management system... These parallel accounting mechanisms – with their long chains of transactions “bolted” onto core Government accounting systems – generate unpredictability and undermine implementation capacity...

In contrast to their strong influence on utilisation rates, rural water supply financing modalities only had a weak effect on the quality and sustainability of schemes built by decentralised service delivery units. The targeting of interventions, the quality of service development, and institutionalisation of cost recovery were satisfactory across all financing modalities.

*Source:* World Bank (2009), p. 70-71.

Other documented benefits include improved accountability (stronger relations between line ministries and/or decentralised entities and ministries of finance); enhanced capacity (through the use of country systems and focused and coordinated support) and better quality of donor-recipient dialogue (more focused on policies and strategies, enhanced trust, better donor insight on key institutional and capacity constraints). See the literature review on the benefits of using country PFM systems (OECD and Mokoro 2010) for further information and examples.

## Using country PFM systems: what does it mean in practice?

In order for aid to “use country systems”, it has to pass through some or all of the components in existing mainstream national systems, respect the same laws, rules, procedures and formats and be managed by the same institutions.

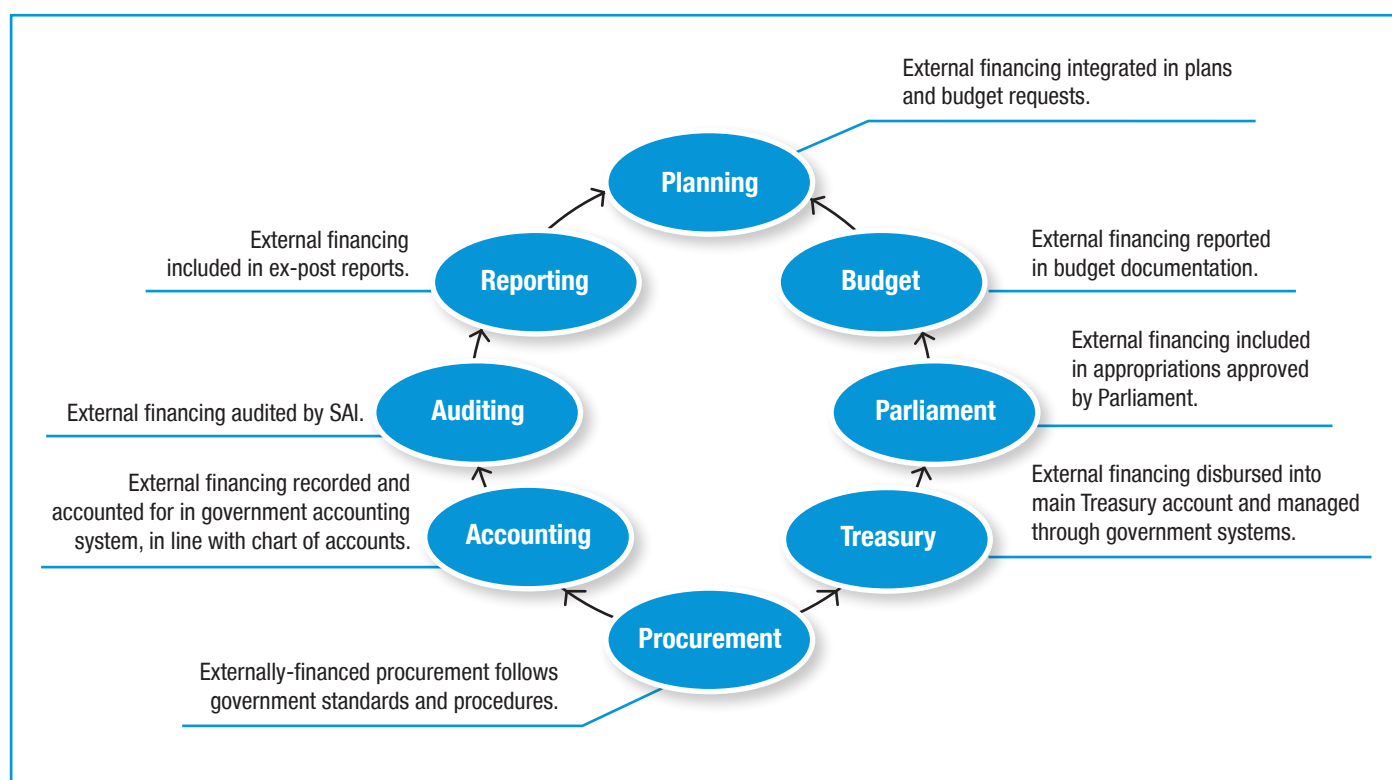
### What are the different components of the PFM system that aid can “use”?

Aid can “use” different phases of the national budget process: planning, budget preparation, approval by Parliament, budget execution through Treasury and procurement, accounting, auditing and reporting (see Figure 1).

One should also distinguish between aid that is *reflected in* (i.e. appears on) the national budget, accounts, or reports; and aid that is *integrated in* (i.e. makes use of) national processes such as budget execution and procurement.

Another important consideration is the extent to which donors actually *rely* on regular country systems, without requiring specific derogations or additional processes. For example, some donors require additional reports to be produced, or specific prior-review or non-objection processes on top of domestic ones.

**Figure 1. Using partner country PFM systems at different stages of the budget cycle**



Source: Derived from Mokoro (2008).

The use by donors of each specific component of PFM systems carries specific benefits, as well as risks and transaction costs. For example ensuring that aid is adequately reflected on plan, on budget or on reports carries minimal risks but may bring about significant benefits in terms of transparency, enhanced budget allocations, ownership and accountability. It may nevertheless imply significant transaction costs for donors, in order to provide information with sufficient details and to follow national budget format, classification and timetable. Decision on which components to use should be taken jointly with partner countries to ensure a balance between the benefits and costs of using the different components of a country system.

### Are country systems relevant for all aid modalities?

Budget support, by definition, uses country systems. But it is a mistake to assume that the use of country systems necessarily implies a shift to budget support. On the contrary, progress can and should be made for every aid modality while recognising the different challenges they present.

Projects, HIPC funds, and pooled funds may all use country systems at different stages in the budget process, but do not automatically do so. Similarly, Programme Based Approaches (PBAs) and Sector Wide Approaches (SWAs) may be implemented through a range of aid modalities and do not automatically imply the use of country systems, although it is one of their objectives in the medium term.

Common funds (or pooled funds) are often considered as a stepping stone towards an increased use of country systems. While they do have the potential for significantly reducing transaction costs compared to individual projects, an ODI study highlights that “the setting up of the arrangements for the common fund absorbs major energies and draws attention away from the strengthening of the sector’s mainstream systems. The effect is that common funds appear less like building-blocks and more like road blocks on the route towards greater use of country systems”. (ODI 2008 p. vi).

Budget Support in principle is the aid modality that makes greater use of partner country PFM systems, but even in this case, the multiplicity of derogations from mainstream domestic systems may minimise benefits. Box 5 below highlights how Sector Budget Support (SBS) which relies fully on country systems may work better than SBS which only partly uses country systems.

#### **BOX 5: EFFICIENCY OF SBS USING FULLY OR PARTLY COUNTRY SYSTEMS**

Case studies across six African countries] point to the negative consequences of many of the common derogations used in the design and implementation of SBS. In summary:

- Traceability of SBS fragments budget allocations, distorts the structure of the budget, undermines overall strategic resource allocation. *[Aid funds are considered traceable in this study when they are separately identifiable in the expenditure classification of the country’s budget, using specific reporting and identification mechanisms]* It skews dialogue towards the areas which SBS is funding and away from the overall budget, and encourages further derogations from country systems. Traceable SBS results in a major share of the dialogue being devoted to the operation of the SBS instrument, at the expense of broader policy and systems issues.
- Additional financial management, audit and reporting requirements are weakly owned, create transactions costs and undermine efforts to improve domestic processes.
- Bypassing normal processes and institutions for service delivery (including service providers and decentralised managers) prevents the strengthening of those systems.
- Derogations from established SWAp processes, and the conditionality frameworks which they embody, add to transaction costs for the recipient and cloud incentives.

Source: Mokoro & ODI (2008), p. 25.

### **What can donors do to accelerate progress?**

Key steps to accelerate progress therefore involve:

- Improving the monitoring (at donor and global level) of the use of country systems for various aid modalities and instruments.
- Ensuring the right skill mix and staffing profile is available especially in country offices; Building capacity of staff through adequate training on partner country PFM systems and the use of country systems; development of manuals and staff guidance material.
- Providing adequate information on ODA forecasts and actual disbursements to partner countries for reflecting aid in plans, budgets, accounts, and reports.<sup>4</sup> This could for example involve using disbursement mechanisms that put Government Ministries, Departments and agencies in charge of execution, in order to enhance information and control over the pace of disbursements and implementation.
- The costs for donors (in terms of time, number of staff, and money) in using country systems have often been underestimated. Shifting from donor systems to partner country PFM systems implies a shift of transaction costs from recipient countries to donor agencies. In addition, most benefits related to the use of country systems require strong donor involvement to materialise, in terms of understanding of country systems, monitoring, dialogue, and overcoming internal difficulties or rigidities within the donor agency itself (such as lack of alignment of fiscal years, standard requirements for financial reports, analysing risks and benefits). This is the case also for budget support. It is therefore essential that donor agencies anticipate these costs and provide for them adequately.
- In their assessment of the risks involved with the use of country systems, donors have so far almost exclusively focused on fiduciary risk. While this is a major constraint and deserves attention, assessing the opportunity of using country systems should be based on a more comprehensive risk/benefit analysis and an assessment of sustainability.

4. See on-going work on this issue in the context of the International Aid Transparency Initiative (IATI).



- Dialogue with donor country Parliaments and Supreme Audit Institutions is essential, focusing on the need for balancing the analysis of risks involved with the use of partner country PFM systems in regard to expected benefits, and developmental risks of not using country systems.
- While donor agencies are committed to “establish additional safeguards and measures in ways that strengthen rather than undermine country systems and procedures” (Accra Agenda for Action para.15), further work is needed to monitor and assess the impact of different measures, and develop less harmful alternatives.
- International fora (such as the Working Party on Aid Effectiveness) with representatives from both donors and partner countries can assist in providing a peer review mechanism as well as a platform for knowledge sharing of costs and benefits of using country systems.

## What role for partner countries?

Specific practices put in place by some recipient countries have facilitated and accelerated the integration of ODA with their PFM systems. They include in particular:

- Stronger links between planning and budgeting, potentially through the establishment of a Medium Term Expenditure Framework (MTEF).
- Definition of clear criteria for inclusion of aid in the budget documentation (budget law, annexes), and specification of the partner government’s information needs with regard to aid flows.
- Revision of the Chart of Accounts and budget classification in order to integrate recurrent and development budgets.
- Implementation of a Single Treasury Account.
- Adaptation of the Treasury management system to include aid in kind and direct payments.
- Strengthening the role of Parliament in the budget process and the quality of its inputs.
- Enhanced dialogue between line ministries and the Ministry of Finance on issues related to budget preparation, budget allocations, budget execution reporting and analysis, and treasury management (predictability of fund transfers etc). Both line ministries and the Ministry of Finance should be adequately informed and involved in discussions with donors on potential requirements for earmarking, additionality, traceability, specific audit or reporting, predictability and conditionality. This should avoid line ministries making commitments that may not be in line with on-going PFM reform processes, or that could be aligned better with country systems and processes.

Box 6 below provides an example of the use of government treasury systems in Mozambique.

### **BOX 6: GOVERNMENT AND DONORS COLLABORATE TO PUT AID ON TREASURY IN MOZAMBIQUE**

The Mozambique government, together with its aid partners, has been working to merge all financial accounts into one single treasury account – Conta Unica do Tesouro, CUT – and to bring all available sources of funding, both international and external, under the umbrella of the Mozambican integrated budget and PFM system. Donor agencies who belong to the Programme Aid Partners group have agreed to disburse at least 60% of its development assistance to the government through the single treasury account system by 2009. Since 2007 some of the larger sectoral funds are now being managed through the CUT and are, therefore, on treasury. These include common funds in agriculture, health and education (as well as a fund that supports PFM reform!).

The establishment of the single treasury account has been instrumental in the process of putting aid on budget in Mozambique and bringing its associated PFM benefits. Its creation directly addresses one of the main causes behind the phenomenon of off budgets: the lack of transparency within the treasury system, which deters donors from using local public financial management systems. At the same time it is perhaps one of the most visible manifestations of the PFM benefits brought by aid capture on treasury, given the immediate benefits the government/treasury draws from having the number of accounts it uses for its treasury operations reduced to one.

*Source: Warren-Rodríguez (2008).*

## Further reading

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2. **Organisation for Economic Co-operation and Development (OECD)** (2009), Managing Development Resources, *The Use of Country systems in Public Financial Management*, Better Aid, preliminary version, OECD Publishing, 9 April 2009, available on internet: [www.oecd.org/dataoecd/29/20/41085468.pdf](http://www.oecd.org/dataoecd/29/20/41085468.pdf).
3. **OECD** (2010), *Practitioners' guide to using country PFM systems*, forthcoming.
4. **OECD** and **Mokoro** (2010), *Literature review: Benefits of using country PFM systems*, produced for the OECD-DAC Task Force on Public Financial Management, August 2010.

## Acronyms and abbreviations

<b>DAC</b>	Development Assistance Committee	<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>HIPC</b>	Heavily Indebted Poor Country	<b>PBA</b>	Programme Based Approach
<b>IATI</b>	International Aid Transparency Initiative	<b>PFM</b>	Public Financial Management
<b>IMF</b>	International Monetary Fund	<b>SAI</b>	Supreme Audit Institution
<b>MTEF</b>	Medium Term Expenditure Framework	<b>SBS</b>	Sector Budget Support
<b>ODA</b>	Official Development Assistance	<b>SWAp</b>	Sector Wide Approach
<b>ODI</b>	Overseas Development Institute		

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9. **World Bank** (2009), *Ethiopia Public Finance Review*, Report No. 50278-ET, Poverty Reduction and Economic Management Africa Region, November 2009.

