WHAT ARE THE BENEFITS OF USING COUNTRY SYSTEMS?

Policy Brief 3

Benefits of using country PFM systems

Policy brief 3: Sector audiences

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.

Recent assessments show that less than half of aid to governments currently uses partner country PFM systems,[1] and that progress has been slow over the past few years.

This briefing is aimed at donor and partner country sector-specialist staff. It provides a general explanation of what using country systems means and why it is important, considers the specific perspective of sector level issues, and highlights the benefits of using country systems and relevant good practices.

Why should sector-level actors be concerned by the use of recipient country PFM systems?

Aid that uses country systems can provide incentives and momentum to strengthen their capacity and performance, enhance domestic accountability mechanisms, and contribute to better PFM practices. It thereby helps to improve the effectiveness of all public expenditure, not just that financed by aid.

The use of recipient country PFM systems involves specific issues at sector level, in terms of risk assessment, choice of aid modalities, and the necessary coordination with national level dialogue and policies.

Different issues stand out in different sectors: international drug procurement may be an issue in the health sector, as well as the challenge of reconciling vertical programmes with country systems; in the education sector, the Fast Track Initiative is striving to ensure alignment with country plans and use of the most aligned aid modality; in the infrastructure sectors, maintenance is a key area often financed by the domestic recurrent budget rather than by specific projects.

Sector issues often intersect with decentralisation, which may complicate the use of partner country systems. The contrasting views of sector ministries and ministries of finance in recipient countries may also challenge alignment with country systems. Finally, the choice of aid modalities, and in particular the nature of Sector Wide Approaches (SWAps) and Sector Budget Support (SBS) provided presents specific opportunities and challenges to using partner country PFM systems.

What benefits can be expected from the use of partner country PFM systems at sector level?

Governments have a crucial role in providing services for sector outcomes. 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.[2]

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 & 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 as opposed to developing parallel ones. This is expected to **reduce the transaction costs** involved in managing aid for partner countries, and to lead to more sustainable improvements in the long term. A recent World Bank study examined eight different financing modalities in support to development of rural water supply in Ethiopia. Its findings (see Box 1) illustrate the high transaction costs generated by donors using parallel procedures, in terms of predictability, utilisation and implementation rates, while generating no benefit in terms of quality and sustainability of the outputs produced compared to modalities using government systems.

BOX 1: 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.

The use of recipient country PFM systems can also **contribute to establishing widely accepted good PFM practices** in recipient countries, in particular comprehensiveness and transparency. It can also contribute to more efficient allocation of domestic resources. This is expected to **make recipient countries' public financial management more efficient as a whole**, including both domestic and external resources. See the example of the education sector in Rwanda detailed in Box 2.

BOX 2: BALANCING RECURRENT AND INVESTMENT EXPENDITURE – SBS TO EDUCATION 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, whereby the increase in sector budget support 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 (2009b), para. 163 and p. 44.

Finally, ensuring that the national budget and public accounts are more transparent and comprehensive, including all relevant information on aid, can **strengthen the domestic accountability processes** between the Ministry of Finance, line ministries, Parliament, the Supreme Audit Institution, and citizens.

Sector characteristics influence the benefits and challenges that may be expected from the use of country systems. Health and education are sectors in which government expenditure is essential, which have in general relatively stronger institutions and policy frameworks, and for which there is usually a clearly defined leading government institution. These elements may facilitate donor-government dialogue and linkages with national level processes, which are crucial in developing the use of country systems.

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

Country PFM systems that are already strong can bring about additional benefits, and reduce the fiduciary risks 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.

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 depends 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.

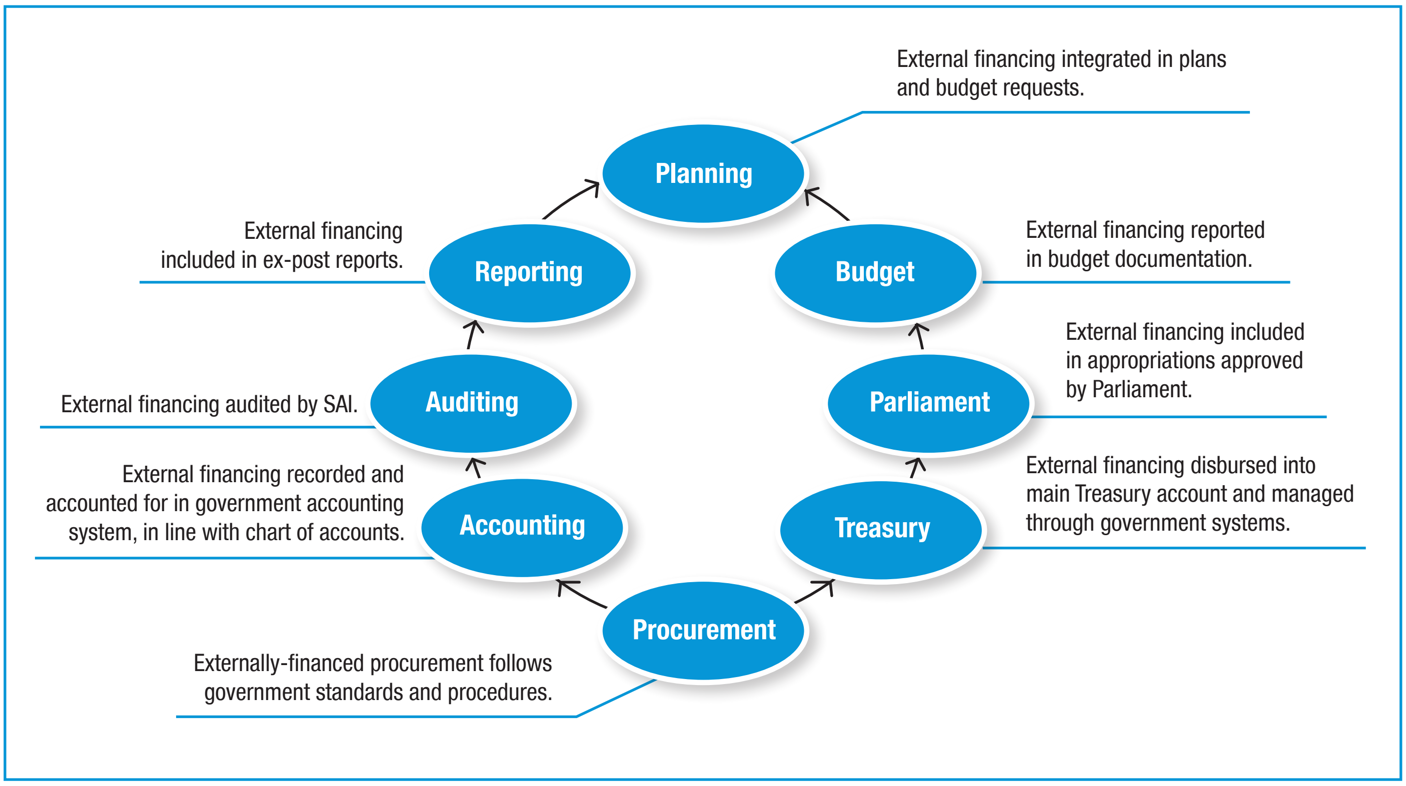
Using country PFM systems in practice at sector level

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"?

The definition of country PFM systems is closely related to the 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).

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



Source: Derived from Mokoro (2008).

How are risks involved with using recipient country PFM systems assessed at sector level?

The use by donors of each specific component of PFM systems carries specific expected benefits, as well as risks and transaction costs. For example, ensuring aid is adequately reflected on plan, on budget or on reports carries minimal risks but may bring about significant benefits in terms of transparency, allocative efficiency, ownership and accountability.

In deciding upon the use of recipient country PFM systems, donors should carry out a balanced analysis of risks and benefits involved, considering both national and sector-specific issues. Box 3 provides an illustration of PFM and risk assessment at the sector level, as carried out by Sida.

BOX 3: SIDA GUIDANCE ON PFM ASSESSMENT AT SECTOR LEVEL

When looking at PFM performance in the sector, it is important to have an understanding of the following:

- the overall PFM system that the sector is part of and needs to operate within;
- the position of the sector within that overall PFM system;
- the additional/complementary PFM systems/procedures that the sector needs for its efficient management of resources; and
- how the general (horizontal) PFM systems at the Ministry of Finance integrate with the sector's complementary systems (vertical). […]

The following questions are particularly important to consider at sector level:

- "Is the sector plan realistic and feasible given the medium-term financing scenario (MTEF)?
- Is the sector budget in line with the sector plan and PRS, and poverty-oriented?
- What are the major risks and constraints of the PFM system affecting service delivery and democratic governance in the sector? […]
- What distribution (and trends in distribution) can be seen between different cost items such as salaries, investments and other recurrent costs? […]
- Do funds reach the sector and its service delivery units on time? Are they effectively transformed into service delivery? What are the main bottlenecks to effectively spending the resources at local/decentralised level (cash flow planning, lack of financial autonomy, poor financial reporting, information to the planning and budget formulation, etc)? […]
- To what extent are central procurement regulations adequate for sector procurement? […]

Is there parallel financial reporting due to separate funding by development partners? What does this mean for the possibility to manage the flow of funds effectively?

Source: Sida (2007), pp. 37, 44.

Are all aid modalities concerned?

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

In addition to broad aid modalities, detailed design issues may be essential in enhancing the alignment with and use of recipient country PFM systems, and minimising harmful derogations.

At sector level, General and Sector Budget Support[3] (GBS and SBS) represent the aid modalities that are potentially most aligned with country PFM processes.

GBS is a relevant aid modality at sector level. It contributes to sector funding, and has the potential for addressing issues related to inter-sectoral budget allocations and relevant national policies such as PFM or civil service reform.

While SBS maintains a specific sector focus which can be more attractive to sector actors, a recent study (Mokoro & ODI, 2009a) notes that the wide range of instruments which are considered as SBS at country level are not all aligned with recipient country PFM processes. In practice, a variety of derogations from country PFM systems are often put in place, in particular different degrees of earmarking and traceability[4] requirements, and additional reporting or audit requirements, which may undermine expected benefits. Box 4 below highlights how Sector Budget Support which relies fully on country systems may work better than SBS which only partly uses country systems.

3. The OECD defines SBS as un-earmarked funding to the national treasury where dialogue focuses on sector rather than overall budgetary issues (OECD 2006).

4. Aid funds are traceable when they are *separately identifiable* in the expenditure classification of the country's budget, using specific reporting and identification mechanisms.

BOX 4: 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. 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, adds to transaction costs for the recipient and clouds incentives.

Source: Mokoro & ODI (2009a), p. 25.

Project aid nevertheless remains the dominant aid modality used at sector level in the vast majority of recipient countries. Efforts to enhance the use of recipient country PFM systems by project aid could therefore reap significant benefits. Table 1 provides an illustration of different types of project aid making use of recipient country PFM systems to various degrees in Mozambique, and the respective benefits/drawbacks in different situations.

Table 1. Different degrees of use of recipient country PFM systems through project aid in Mozambique

Use of recipient country PFM systems	Example of projects	Consequences
Funds which do not belong on state budget.	Support to private sector, funds not under the control of Government.	Sometimes included erroneously on budget, which confuses accountability and responsibility lines.
Funds included in sector plans but not in state budget.	Various projects in the health sector.	Neither Ministry of Finance nor Parliament nor the general public are adequately informed. Increases the dichotomy between planning and budgeting. The role of Ministry of Finance in managing public finance is weakened. Erosion of the accounting system. For funding which does not belong on state budget (such as some projects implemented by NGOs), inclusion on plan is helpful to improve planning and budgeting.
Funds included in the state budget but managed by donors.	Infrastructure projects, projects which provide implementation plans, some pooled funds.	Transparent for Ministry of Finance and Parliament. Increased coverage of state budget. May nevertheless undermine Ministry of Finance accountability to Parliament, and within sector ministries, departments of planning vis a vis departments benefiting from donor funding.
Funds included in the state budget and transferred through the single treasury account.	Some Government-managed programmes (education, support to urban water and sanitation); some pooled funds (at least in theory) [in total only 5-10% of all project support].	Transparent for Ministry of Finance, Parliament and auditing. Enhances control, supervision and management of liquidity. More efficient management of funds.

Source: Derived from Hodges and Tibana (2004), and IGG and Alliance (2015 and 2010).

How to manage the transition from the use of parallel systems to the use of recipient country PFM systems in support of a sector?

An important element at sector level is the need to anticipate and manage the transition from using parallel systems to using country systems. In particular, it is essential to consider the following points:

– Government institutions may require adequate capacity strengthening in order to manage the additional inflow of funds. For example the unit in charge of construction in a Ministry of Education would need additional staff and capacities in order to manage a higher proportion of education funding for construction. District agriculture units may require further strengthening to manage extension services.

– Adequate safeguards and transition measures should be designed to limit the risks that sector or decentralized service providers may "lose out", in particular in terms of budget allocations or predictability of disbursements. Nevertheless, this should be done in ways that strengthen national processes rather than bypassing them, focusing on enhancing the dialogue between line ministries, service providers and the Ministry of Finance. This requires a thorough understanding by donor sector staff of recipient country PFM systems at national and sector level.

– Specific incentives may play out at sector level compared to national level, and at the decentralised level compared to the national level. On the donor side, there may be a requirement to demonstrate specific sector results and where funding is going, requiring traceability and visibility. Staff qualifications may need to be strengthened to ensure better understanding of aid effectiveness or recipient country PFM systems. On the recipient side (line ministries, departments receiving donor funds within line ministries, decentralised entities) there may be a perception that project or off-budget funding is more predictable, reliable, or under their control. It is also more likely to generate advantages such as vehicles or per diems.

The example of common funds (or pooled funds) illustrates the difficulties in managing the transition toward the use of recipient country PFM systems at sector level. Common funds are often considered as a stepping stone toward an increased use of country systems. While they do have the potential for significantly reduce transaction costs compared to individual projects, the ODI study referred to in Box 5 below concludes that "common funds appear less like building-blocks and more like road blocks on the route towards greater use of country systems" (ODI, 2008d, p.vi).

BOX 5: COMMON FUNDS: BUILDING BLOCKS OR STUMBLING BLOCKS TOWARD THE USE OF RECIPIENT COUNTRY PFM SYSTEMS?

CFs [Common Funds] can serve to undermine sector service delivery systems more than traditional projects and distract co-ordination mechanisms away from core policies and systems, owing to their scale and the involvement of multiple donors. Once created, they overshadow domestic delivery systems and are difficult to take apart. … Attention is diverted away from vital strategic sector policy issues and mainstream domestic systems. The establishment of CFs for priority sub-sectors can be particularly damaging. A 'silo mentality' can emerge and undermine the benefits from an overall increase in sector resources by reducing governments' discretionary capacity to allocate resources to sector priorities overall. CFs can easily undermine the working of domestic accountability systems, drawing attention to the accountability demands of the funding modality itself and undermining the needed focus on the delivery of policy objectives overall. For all these reasons, the vision of CFs as 'transition mechanisms' towards more effective aid to service delivery appears destined to fail. In certain circumstances, they may do more harm than traditional projects.

Source: ODI (2008d), p. xii.

Linking sector and national level efforts to use partner country PFM systems

On the donor side, enhanced and pro-active collaboration between sector specialists and generalists/macro-economists/PFM specialists should focus on:

– ensuring complementarity between GBS and sector-level funding, conditions and dialogue;

– ensuring that national-level PFM reforms are followed through to the sector level, and that feedback from sectors contributes to improvement of these reforms;

– ensuring that sector specialists have adequate understanding of the key elements, timeframe and constraints of the budget process and PFM system at national level; and

– ensuring that dialogue or conditionality related to lifting the PFM constraints at sector level (budget format, budget execution reporting, specific procurement issues, treasury management etc) are fully coherent with national-level reform processes.

On the partner government side, it is essential for line ministries to liaise efficiently with the Ministry of Finance on issues relating 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. For example, donor traceability requirements could be converted to less harmful measures, such as enhanced monitoring of budget allocation and execution, combined with specific commitments with regards to the execution of specific programmes or budget lines and "protection" from budget cuts.

Further reading

1. **Mokoro** (2009), *Good practice note: using country budget systems,* prepared for the Collaborative Africa Budget Reform Initiative, April 2009, available on internet: *http://cabri-sbo.org/cabri%20gpn%20eng%20proof%204%20final.pdf.*

2. **OECD** (2010), *Practitioners' guide to using country PFM systems*, forthcoming.

3. **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

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

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2. **IGG and Alliance** (2010, 2015), *Aid and budget transparency in Mozambique. Constraints for civil society, the Parliament and the Government,* The Informal Governance Group and Alliance 2015, May 2010.

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4. **Mokoro & ODI** (2009a), *Sector Budget Support in Practice: Synthesis Report.,* Mokoro and ODI, Tim Williamson and Catherine Dom, final draft, 28 November 2009.

5. **Mokoro & ODI** (2009b), *Sector Budget Support in Practice: Case study – Education Sector in Rwanda,* Mokoro and ODI, Mailan Chiche, April 2009.

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