

Managing Fiduciary Risk When Providing Direct Budget Support

CONTENTS

PAGE

1	Summary	1
2	Purpose and scope of paper	3
3	Background	3
4	DFID's fiduciary requirement	5
5	Assessing and managing fiduciary risks	7
6	Use of codes and standards	8
7	Monitoring performance and responding to problems	10
8	Resource implications	12
Annex A	Weighing the risks and benefits of Direct Budget Support	13
Annex B	Fiduciary risks and suggested safeguards	17

I. SUMMARY

1.1 The increasing adoption of poverty reduction strategies presents an important opportunity to reform the relationship between donors and developing countries. Donor assistance should be provided in a way that builds, rather than undermines, recipients' sustainable capacity to design and implement these strategies. This paper is concerned with the provision of development funds directly to recipient governments to be spent as part of their budgets (i.e. direct budget support). This way of providing financial aid has a number of potential advantages over projects. It can strengthen local ownership and make governments more accountable to their people. It can enhance long term financial planning by recipient governments. It provides greater incentives for both donors and recipient governments to strengthen the effectiveness of government systems. And it enables substantial savings in the transaction costs of aid delivery.

1.2 This paper is concerned with managing "fiduciary risk" when UK development funds are given as direct budget support. As with all aid, DFID is accountable to Parliament for ensuring that its expenditure on direct budget support is properly accounted for, used for the intended purposes and that the expenditure represents value for money. This is referred to in this paper as DFID's fiduciary requirement. The risk that its expenditure will not be used in this way is referred to as the fiduciary risk. This paper uses the term fiduciary risk in the sense of the risks arising from the public financial management and accountability systems and their operation.

1.3 When funds are granted to the recipient government for direct budget support DFID is not directly responsible for the use of those funds. Rather, DFID is responsible for making a sound ex-ante assessment of the effectiveness of the recipient government's systems and practices, deciding whether the level of risk is acceptable, and taking appropriate steps to mitigate and monitor the risks.

1.4 One important indicator of the likelihood that budget support will result in poverty reduction is whether the recipient government's public expenditure management systems are effective. Although most developing countries do not currently meet international standards, DFID may provide direct budget support, provided:

- a thorough evaluation of public financial management and accountability systems, and associated risks, has been carried out;
- the government has a credible programme to improve standards of these systems;
- the potential developmental benefits justify the risk, taking account of any safeguards that can be put in place to buttress and develop these systems; and
- these assessments are explicitly recorded as part of the decision-making process to provide assistance.

Each case should be considered on its merits with DFID balancing fiduciary and other risks against the potential developmental benefits. Plans to improve public financial management and accountability should include measurable targets and agreed monitoring arrangements. Where additional safeguards are necessary, they should be designed to support and build government systems and avoid bypassing or undermining them. This approach has been agreed with the UK's National Audit Office.

1.5 Where fiduciary risks cannot be mitigated sufficiently, DFID should not normally enter into direct budget support arrangements. In these circumstances, it may still be possible to begin moving towards a direct budget support arrangement. For example, donor funds can be pooled and reflected in the government budget but kept separate from government funds. In such situations, DFID should work with partner countries to promote progression towards full integration into the budget.

1.6 DFID is working with other development agencies and international financial institutions to harmonise approaches to fiduciary risk management, thereby limiting the burden placed on governments to meet the requirements of different donors and lenders. This includes harmonisation of donor assessment procedures, and the identification of generally accepted standards of good practice.

1.7 DFID is devoting more resources to helping developing countries governments strengthen public financial management and accountability.

2. PURPOSE AND SCOPE OF PAPER

2.1 This paper provides guidance to DFID staff on how the public expenditure management elements of fiduciary risks should be assessed and managed where DFID provides funds directly to recipient governments to be spent as part of their budgets (direct budget support). It also sets out DFID's approach to the use of additional safeguards to provide assurances that the effect of budget support will be poverty reduction, and proposes some future directions for collaboration with other development agencies to harmonise approaches to assessing fiduciary risk and developing international standards.

2.2 The remainder of this paper is organised as follows

Section III	Background
Section IV	DFID's Fiduciary Requirement
Section V	Assessing and Managing Fiduciary Risk
Section VI	Use of Codes and Standards
Section VII	Monitoring performance and responding to problems
Section VIII	Resource Implications
Annex A	Weighing the risks and benefits of Direct Budget Support
Annex B	Potential risks and suggested safeguards

3. BACKGROUND

3.1 Direct Budget Support (DBS) is a form of programmatic aid in which funds are provided:

- in support of a government programme which focuses on growth and poverty reduction, and transforming institutions (especially budgetary); and
- to a partner government to spend using its own financial management and accountability systems.

DBS can take the form of a contribution to the overall budget (sometimes referred to as macro or general budget support) or with notional hypothecation agreed with the recipient government (usually referred to as sector budget support)¹.

3.2 DFID is committed to channelling more of its financial aid as DBS through developing country budgetary systems where governments have a strong commitment to poverty reduction (*White Paper on Eliminating Poverty: Making Globalisation Work for the Poor*, 2000). This reflects the belief that DBS has a number of potential advantages over projects:

- It can strengthen local ownership and make governments more accountable to their people by

reducing the proliferation of donor conditionality and enabling donors to focus their support on the government's implementation of its poverty reduction strategy;

- It enables donors to provide governments with greater certainty about donor flows over the medium term which, in turn, gives governments the assurances needed to plan service delivery improvements;
- It provides greater incentives for both donors and recipient governments to strengthen the effectiveness of government systems. A switch from project financing using parallel systems to reliance on government systems focuses attention on the effectiveness of the latter;
- And it enables substantial savings in the transaction costs of aid delivery through the dismantling of separate project structures.

3.3 In order to have a reasonable expectation that such transfers will result in poverty reduction, it is important to make an assessment of the government's overall policy framework and its capacity to use resources effectively. This has significant implications for the way in which DFID accounts for and monitors aid:

¹ Direct Budget Support used in this sense excludes programmatic funding which bypasses the central exchequer of a recipient government – such as funds provided directly to a sector ministry or pooled with other donors' funds outside of the government system. The approach to assessing and managing fiduciary risk set out in this paper nonetheless applies equally to these other forms of programmatic funding.

3. BACKGROUND

- After transferring resources into the budget of a recipient government DFID money can no longer be tracked and accounted for separately;
- Value for money will depend on the policies and priorities of the government, and the effective operation of its systems for managing its resources, in particular procurement and payroll;
- The effectiveness of expenditure needs to be measured in terms of budget outputs and outcomes relative to government policy objectives.

3.5 Fiduciary risk (in the sense used in this paper) is only one factor to be considered when deciding what form of support to provide. There will be prior issues to consider when determining whether or not to provide budget support, including government commitment to addressing poverty, and the effectiveness of economic management.

Where DBS is being considered there is a clear need for practical advice on the assessment and management of fiduciary risk, applicable to the range of different country circumstances.

3.4 The Heavily Indebted Poor Countries (HIPC) initiative has helped to focus international attention on how governments are using and accounting for the resources freed up by the reduction in debt repayments and interest. Development agencies and governments have recognised that joint approaches to assessment of public financial management systems, institutional strengthening and monitoring will reduce transaction costs bringing benefits for all parties. International initiatives are now underway in the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) and the Strategic Partnership with Africa (SPA) to harmonise approaches. Collaboration with other agencies, both in the field and at the international level, is increasingly becoming an essential part of DFID's work to improve aid effectiveness.

4. DFID'S FIDUCIARY REQUIREMENT

4.1 Under Government Accounting Rules DFID's Accounting Officer is responsible to Parliament for ensuring the propriety and regularity of the public finances under his or her control, the keeping of proper accounts, the avoidance of waste and extravagance and for seeking economy, efficiency and effectiveness in the use of resources. The Accounting Officer is also responsible for ensuring that funds are applied only for the purposes and to the extent authorised by Parliament. The risk that funds will not be used in this way is referred to as the fiduciary or accounting risk. In principle, this should encompass all those factors that may affect achievement of the desired purposes in a way that represents value for money – not only the effectiveness of government financial systems and practices but also other factors such as economic policy, sectoral policy and the degree of accountability. However, this paper follows the widely held practice of using a narrow interpretation that is limited to the risks arising from government financial management systems and practices.

4.2 DFID is not directly accountable for the use of funds once they have been transferred to a foreign government, as is the case with DBS, and the jurisdiction of HM Treasury and the National Audit Office does not extend into the affairs of recipient governments. Instead, DFID is expected to demonstrate that individual DBS operations are likely to represent an effective use of aid. This depends, in turn, on how effectively the recipient governments' systems make use of resources. DFID's internal procedures should therefore focus on an assessment of whether it is reasonable to expect that the resources transferred will be used for the intended purposes, properly accounted for and that the expenditure will represent value for money. This will require an assessment of:

- government expenditure plans and related development outcomes;
- the effectiveness of public financial management and accountability systems and practices;
- fiduciary risks inherent in these systems and practices;

- the adequacy of any proposed measures to mitigate fiduciary risks.

4.3 In the context of DBS the following definitions have been used:

- **"Used for the intended purposes"** means used in accordance with a programme agreed between donors and a recipient government that supports a recipient government's poverty reduction policy and associated medium term expenditure framework.
- **"Properly accounted for"** means that each accountable unit prepares financial statements reporting actual expenditure, that are independently verified and produced to a reasonable degree of accuracy and timeframe.
- **"Value for money"** can be broadly defined as incorporating the concepts of economy, efficiency and effectiveness in the use of resources. Within government systems key issues in ensuring value for money are:
 - the design of government policies and programmes;
 - the effectiveness and transparency of public procurement;
 - effective management of personnel and payroll;
 - the capacity of the system to absorb additional resources and convert them into the delivery of services;
 - the extent of transparency and the risks of corruption, especially in the procurement of goods and services.

4.4 In most of the poorest countries which DFID supports, public financial management and accountability systems fall well below internationally accepted standards of

4. DFID'S FIDUCIARY REQUIREMENT

good practice (see section VI below on the use of standards). However, in such circumstances DBS may still offer the most effective means of delivering development assistance. Where this is the case DFID may provide direct budget support provided that:

- a thorough evaluation of public financial management and accountability systems, and associated risks, has been carried out;
- the government has a credible programme to improve standards of these systems;
- the potential developmental benefits justify the risks, taking account of any safeguards that can be put in place to buttress and develop these systems; and
- these assessments are explicitly recorded as part of the decision-making process to provide assistance.

4.5 When there is a high level of fiduciary risk involved in channelling money through government systems, DFID should seek to agree with government and other donors long-term and short-term risk reduction measures. If the fiduciary risks cannot be reduced to an acceptable level, given the developmental benefits, DFID should not provide DBS. Where the case for DBS involves acceptance of a particularly high level of fiduciary risk (e.g. when a country is engaged in military conflict) specific approval should be sought from DFID's Accounting Officer.

4.6 Where the conditions for DBS do not exist, DFID may still be able to adopt some of the principles of budget support, and create incentives for improved financial management, while retaining control over the use of funds. For example, donor funds can be included in the government budget but kept physically separate, either under direct donor control or in separate bank accounts. Any arrangements of this kind should be designed to be temporary, and parallel efforts should be made to support and develop, the government's own systems

4.7 DFID can also differentiate between sectors, and within sectors, on the basis of the quality of financial management practices. In some cases, DFID has placed resources under the control of budget centres, where they have demonstrated the ability to manage and account for resources. This has helped to create incentives for improved financial management, but it involves regular assessment of the performance of budget centres.

5. ASSESSING AND MANAGING FIDUCIARY RISKS

5.1 There are three steps in DFID's handling of risks arising from DBS. First, risks should be identified and their significance evaluated. Second, decisions should be taken about which risks can be managed by the adoption of safeguards. Third, an assessment should be made whether the resulting risks are acceptable given the expected benefits.

5.2 Risk identification and evaluation will require a thorough initial assessment of a recipient government's overall policies and capacity, including its public financial management and accountability systems. In the case of general budget support, this means considering the entire public expenditure management system. In the case of sector budget support, this implies consideration of the system within the designated sector, though in practice, many aspects of financial management tend to be centralised, so assessing the systems within the designated sector is likely to require assessment of public financial management overall.

5.3 The assessment need not be carried out by DFID (and indeed is best done as a collectively supported exercise), but DFID should be satisfied that it is sufficiently thorough and objective. A World Bank Country Financial Accountability Assessment (CFAA), or exercise of comparable scope and rigour, should be undertaken supplemented by additional analysis where necessary. As well as reviewing the mechanics of the public expenditure management system, the review should assess the broader accountability framework, including the effectiveness of independent scrutiny of the executive by the legislature, external audit and civil society organisations. Section VI provides guidance on the benchmarks to aid assessment.

5.4 The preparation of complete, accurate and timely accounts of actual expenditure provides an important piece of evidence that DFID DBS will deliver the intended benefits. Consideration should be given to in-year reporting of expenditure, to allow monitoring of adherence to the budget, and annual year reports which have been independently audited. Where these are weak short-term and long-term measures can be taken to help governments improve the reliability and timeliness of accounts (see Annex B).

5.5 Procurement is also a critical area of fiduciary risk, especially where transparency is low and the risks of corrupt practices are significant. Key considerations in assessing the effectiveness of procurement processes are:

- the quality of procurement procedures, including appropriate use of competition and less costly alternatives, well-recorded reasoned decision making and strategies for major procurements;
- the quality, number and authority of procurement staff; and
- independence from political influence.

A World Bank Country Procurement Assessment Review (CPAR), or equivalent, should be carried out in addition or as part of the financial accountability assessment. Where risks are high, short-term and long-term measures can be taken to help governments improve the effectiveness of procurement (Annex B).

5.6 DFID is working within the SPA and the DAC to promote joint fiduciary assessments by development agencies. Bilaterally, we are supporting efforts by the World Bank to merge the CFAA, the CPAR and the Public Expenditure Review into a single fiduciary assessment process, which can be relied upon and participated in by recipient governments, the World Bank and other development agencies.

5.7 By their nature, some risks will be easier to manage than others. Annex B (Fiduciary Risks and Suggested Safeguards) provides more information on fiduciary risks and techniques for managing them, both temporary and longer term. This does not represent a presumption of required actions, but a menu of possible approaches. Measures should, whenever possible, form part of a programme to build government capacity and avoid the creation of parallel structures. Where reliance is being placed on a recipient government's commitment to improve financial management, an agreed action plan should be provided. This should include defined targets and milestones together with agreed monitoring arrangements. Performance monitoring is discussed in more detail in section VII.

5. ASSESSING AND MANAGING FIDUCIARY RISKS

5.8 The acceptable level of fiduciary risk, adjusted for any safeguards, will be a matter of judgement in each case. There is no universal level of risk that should be tolerated for all development assistance. Risks should not be considered in isolation but weighed against expected benefits. Where the developmental arguments in favour of direct budget support are strong, a higher level of fiduciary risk may be justifiable. Annex A provides further guidance on how to consider the level of risks that are acceptable given expected benefits.

6. USE OF CODES AND STANDARDS

6.1 At present, international codes and standards provide only partial coverage of public financial management and accountability practices. A number of international standards setting agencies and professional bodies, such as the International Federation of Accountants (IFAC) and the International Organisation of Supreme Audit Institutions (INTOSAI), have developed, or are in the process of developing, international standards on public sector accounting and auditing. These tend to represent best practice in OECD countries.

6.2 The International Monetary Fund (IMF) Code on Fiscal Transparency defines a broader set of desirable principles and practices in relation to public financial management. These cover:

- clarity of roles and responsibilities
- public availability of information
- budget preparation, execution and reporting, and
- independent assurances of integrity.

The Code is a valuable reference point and is more relevant to the concerns of developing countries. However, it does not define best practice. Neither does it address the efficiency of public spending nor the soundness of public finances.

6.3 A recent review of public financial management and accountability practices in 25 HIPC countries revealed that they fall far short of international codes and standards. Most fail to meet basic tests of adequacy². Given both the impracticality of achieving compliance with international codes and standards in the short or medium term and gaps in the architecture of codes and standards, DFID believes that priority should be given to developing a set of benchmarks linked to codes and standards, which can be used to measure performance and set targets for improvement.

6.4 DFID proposes to use the following benchmarks as the basis for carrying its own fiduciary risk assessment:

² Tracking of Poverty-Reducing Public Spending in Heavily Indebted Poor Countries (IMF, 2001)

6. USE OF CODES AND STANDARDS

GOOD PRACTICE PRINCIPLES	BENCHMARKS FOR ASSESSMENT
A clear set of rules governs the budget process	<p>A budget law specifying fiscal management responsibilities is in operation.</p> <p>Accounting policies and account code classifications are published and applied.</p>
The budget is comprehensive.	<p>All general government activities are included in the budget.</p> <p>Extra budgetary expenditure is not material</p>
The budget supports pro-poor strategies.	Budget allocations are broadly consistent with any medium term expenditure plans for the sector or for the overall budget.
The budget is a reliable guide to actual expenditure	Budget outturn shows a high level of consistency with the budget.
Expenditure within year is controlled	<p>In-year reporting of actual expenditure.</p> <p>Systems operating to control virement, commitments and arrears.</p>
Government carries out procurement in line with principles of value for money and transparency.	<p>Appropriate use of competitive tendering rules</p> <p>Decision-making is recorded and auditable.</p> <p>Effective action taken to identify and eliminate corruption.</p>
Reporting of expenditure is timely and accurate.	<p>Reconciliation of fiscal and bank records is carried out on a routine basis.</p> <p>Audited annual accounts are submitted to parliament within the statutory period.</p>
There is effective independent scrutiny of government expenditure	<p>Government accounts are independently audited.</p> <p>Government agencies are held to account for mismanagement.</p> <p>Criticisms and recommendations made by the auditors are followed up.</p>

6. USE OF CODES AND STANDARDS

These benchmarks draw on the minimum standards proposed in the IMF's Manual on Fiscal Transparency, and the benchmarks identified in the review of HIPC countries public expenditure management systems carried out by the IMF and World Bank in January 2001. They are intended to be temporary and will be replaced when there is a broader international consensus on codes and standards and their use. The IMF, the United Nations (UN), the World Bank, other multilateral development banks and the DAC, are already working with international standards setting bodies to this end. DFID will continue to contribute to this work.

6.5 Many countries which are committed to pro-poor policies, and which are striving to improve public sector financial management, do not yet meet these benchmarks. Failure should not prevent DBS being put in place provided DFID has been through the process referred to in paragraph 4.4 and is satisfied that the fiduciary risks are acceptable given the expected developmental benefits.

7. MONITORING PERFORMANCE AND RESPONDING TO PROBLEMS

7.1 Before entering into an agreement to provide DBS, DFID should agree mechanisms not only for assessing the outputs and outcomes resulting from the donor supported poverty reduction programme but also for monitoring fiduciary risk and measuring progress in improving government systems. (Where government systems are too weak to enable these we should ensure that alternative monitoring arrangements are compatible with their strengthening and that capacity building is undertaken.). Fiduciary risk monitoring should be designed to answer the following basic questions:

- Whether reporting is accurate and timely;
- Whether actual expenditure matches the agreed budget allocations;
- Whether value for money and transparency have been demonstrated in procurement;
- Whether the objectives for which funds were allocated have been achieved;
- What progress has been made towards improving financial management.

The CFAA, or an equivalent review of government systems and processes, should be used to establish a baseline, supplemented by additional baseline information on objectives, against which government and development agencies can measure progress.

7.2 Increasing recognition is being given internationally to the importance of strengthening government monitoring systems, including management systems of spending/line ministries – not only to demonstrate the impact of poverty reduction policies but also to help assess the causes of poverty and the contribution of particular government activities in its reduction. To enhance this learning process and to increase the accountability of a government to its people, the main monitoring tools should wherever possible be a government's own reports, including;

- In-year financial reports
- Annual audited accounts of government expenditure
- Expenditure tracking surveys
- National statistical surveys
- Reports from the supreme audit institution
- Reports from parliamentary scrutiny committees.

These may be supplemented by other sources, such as independent audits commissioned by donors and Non Governmental Organisations (NGOs), and externally supported assessments including Public Expenditure Reviews, IMF Reports on Standards and Codes (ROSC), IMF "Red Cover" reports etc.

7. MONITORING PERFORMANCE AND RESPONDING TO PROBLEMS

7.3 Monitoring should be carried out according to a timetable agreed with a recipient government in advance. This should be tied in to the government's budget cycle, the release of government accounts and the availability of statistical and other data, which provide information about outcomes and outputs. Where budget support is linked to the implementation of the government's Poverty Reduction Strategy (PRS), target setting and monitoring for improvements in public financial management should be integrated into any overall monitoring framework for PRS implementation.

7.4 One donor alone cannot generally assess the effectiveness of government monitoring systems, and complement these where necessary. Responsibilities should be shared amongst the donors providing support. In the case of general budget support it may be most appropriate for DFID to focus on one or two sectors. DFID should ensure that arrangements, whether conducted by DFID or other donors, cover the key elements of the government's poverty reduction programme.

7.5 Monitoring of a government's programme to improve the performance of its financial management and accountability systems may identify weaknesses in implementation. In determining how to respond donors should apply the same principles as to any substantive weaknesses in delivery its poverty reduction strategy:

- Every effort should be made to avoid stopping or reducing funding during the year. The main purpose of in-year monitoring should be to identify problems early, in order to allow the government time to resolve them before final decisions must be made about funding levels for subsequent years. If sufficient progress has not been made by this time, it may be necessary to reduce or curtail funding for the next year;
- Problems should be tackled, if possible, by modifying the way in which funding is provided, including the introduction of additional safeguards (see Annex B), rather than by stopping funding;
- The initial agreement should identify fall-back positions, allowing DFID to modify the method of providing funding and to reduce and eventually stop funding in the event of serious, unresolved problems;
- Budget support should not be subject to an all or nothing approach. Instead, it should generally change gradually over time, reflecting the recipient government's success in tackling poverty.

8. RESOURCE IMPLICATIONS

8.1 The renewed focus on improving the effectiveness of public expenditure management systems has resource implications both for DFID and recipient governments. Within DFID lead responsibility for public expenditure management lies with Governance Department, but very close co-operation is required between Governance and Economic Advisers and Procurement Department, both to develop policy and support programmes in the field.

8.2 It is apparent that DFID will need to increase the quantity, and ensure the quality, of resources available to advise on public financial management issues, carry out assessments of government systems and implement and monitor programmes to strengthen government systems. This will be addressed in the following ways:

- Training of DFID staff, especially Governance and Economic advisers to improve their expertise;
- Increasing the number of professional advisers with background in public financial management and procurement;
- Improving our knowledge of and access to external expertise;
- Lesson learning and dissemination of best practice guidance;
- Participating in work at international level to agree common approaches to assessment, develop appropriate standards and encourage other development agencies to accord a high priority to improving public expenditure management and procurement.

8.3 At the level of country programmes, DFID will need

to devote more resources to assessment work, short-term safeguard measures and long-term programmes to strengthen public financial management and accountability systems, including procurement.

8.4 In order to reach an acceptable standard of public financial management, most developing countries will have to make substantial and sustained investments in upgrading systems and developing the skills to operate and maintain them. While DFID and other development agencies can help with the investment, sustainability will remain a challenge for as long as the public sector fails to attract, motivate and retain suitably qualified professional staff.

WEIGHING THE RISKS AND BENEFITS OF DIRECT BUDGET SUPPORT

INTRODUCTION

1. Development assistance is an inherently high-risk activity. The countries that are in greatest need of assistance are necessarily those that are most prone to natural disaster, external economic shocks, capacity constraints and political instability. They also tend to have incomplete and unreliable information on which to base assessments of both risks and benefits. Many of the risks are beyond the control of DFID or the recipient country government. However, important elements of risk are controllable and the process of risk assessment and mitigation is critical to effective aid delivery.
2. The ultimate benefit that DFID seeks from the support it gives is poverty reduction, as measured by progress towards the Millennium Development Goals. There are also important intermediate benefits that have demonstrable links to poverty reduction, such as improvements in economic and political governance. Development objectives are specific to the context of each country and are set out in country strategies.
3. The process of assessing risks and benefits is not exact or mechanistic. While some can be easily quantified and costed, others are less susceptible to this sort of analysis. In the end, informed judgements will have to be made. The development process is essentially forward looking and decisions should therefore be based on what is likely to happen, taking account of the evidence about the prevailing situation and past track record.
4. The level of acceptable risk will vary according to the extent of benefits expected. Transformational activities, by seeking to bring about wide-ranging beneficial change, may warrant toleration of a higher degree of risk than more transactional activities. For example, the provision of direct budget support, by helping to catalyse improvements in the effectiveness of government systems as a whole, may warrant a higher degree of risk than a donor managed project parallel to the government system with minimal impact outside of the project area and sub-sector.
5. Fiduciary risk is one element of risk and should be considered in the context of an overall assessment of the risks and benefits of a particular aid operation. The matrix (below) attempts to set fiduciary risk in the context of a systematic approach, which puts together the various components of risk and the benefits and identifies a hierarchy.

BENEFITS OF DIRECT BUDGET SUPPORT AND CORRESPONDING RISKS

6. For each of the main potential benefits from a direct budget support operation there will be a corresponding set of risks. These are summarised in the table below. Some of these are generic to any DFID programme or project, but others relate directly to the form which aid takes. For example, predictable delivery of resources may be a benefit of both direct budget support and project aid. However, the consequence of direct budget support may be to increase both the benefit and the corresponding risk, if conditions for budget support are not maintained.

RESPONSE TO RISKS

7. Once risks have been identified and their significance assessed, donors must decide whether the risks:
 - can be **tolerated**,
 - **transferred**,
 - **treated**,
 - or **terminated** by not pursuing DBS.

8. In the case of DBS the focus will be on treating risks, and having identified ways of doing so, deciding whether the resulting risks can be tolerated, given the expected benefits, or whether they should be terminated by pursuing an alternative approach. A number of approaches can be taken to treat risk:
 - Support for capacity building
 - Provision of additional safeguards (see Annex B)
 - Requirement for prior actions by the recipient before effectiveness
 - Agreement in advance on actions to be taken in the event of non-performance
 - Joint working with other donors.

BENEFITS AND RISKS OF DIRECT BUDGET SUPPORT (DBS)

ISSUE	BENEFITS	RISKS	COMMENTS
1. Accountability	Enables donors to remove obstacles created by past aid delivery mechanisms to enhance recipient government accountability to its own people.	DBS leads to more intrusive policy dialogue that undermines recipient government accountability to its own people.	DBS can enhance recipient government accountability if it leads to donors simplifying policy conditionality and policy dialogue respects the government-led poverty reduction strategy process. However, the reverse will be the case if DBS is used merely to add an additional, more macro layer of policy dialogue, to existing policy conditionality.
		Loss of direct donor accountability for use of aid leads to perception that less able to account for use of aid.	This risk is greater when public support for aid is based on a concern about the direct benefits of aid to the exporters and consultants of the donor country and on a narrower focus on the use of the donor funds. This risk is less likely when public support is based on success in reducing poverty and the contribution of all government funds (donor and own resources) in achieving this.
2. Capacity Building	Stronger incentives for donors and governments to give to build capacity of government systems.	Donors and government may overestimate ability of government systems to accommodate responsibilities switched from projects resulting to poorer service delivery.	The assessment of these risks and benefits will depend in part on the relative weight given in specific cases to long term capacity building and achieving short term outcomes. Political pressures for immediate results (e.g. a forthcoming election) may, for example, result in less emphasis being given to long term capacity building than a case where a government has received a recent overwhelming mandate for reform.

ISSUE	BENEFITS	RISKS	COMMENTS
3. Better pro-poor expenditure outturn	Expenditure on pro-poor programmes increased as more resources channelled through activities consistent with poverty reduction strategy.	Perceived risk that DBS more fungible than projects with resulting leakage to activities which are not pro-poor.	Project funding can be as fungible as DBS. Yet DBS more likely to be associated with a policy dialogue on the allocation of expenditure over the whole budget.
4. Predictability of donor resources	Here predictable donor flows enable government to commit increased resources over medium-term to better service delivery (e.g. the greater certainty might enable more teachers to be appointed or for a pay rise for key skills).	As more donors move to using DBS with similar trigger points, donor flows may be more variable than with project and pooled funding.	Realisation of the benefits requires that donors make multi-annual commitments that are not subject to arbitrary cancellation but a transparent graduated response to weaknesses in a government's implementation of its poverty reduction strategy. In-year tranches suspended only where there are exceptional grounds for doing so.
5. Transaction Costs	Transactions costs reduced for donors and government by switch from projects to DBS.	In short-term transaction costs may rise as donors use both DBS and projects in transitional phase and more donors engaged in higher-level policy dialogue.	Transaction costs can be reduced by greater harmonisation between donors and by some becoming silent partners.
6. Focus on Results /Presentational Issues	Encourages greater focus on the outputs and outcomes of the totality of government and donor resources.	Greater presentational risks of corruption scandals in beneficiary government.	Risk lower to the extent that a) public is primarily concerned about poverty reduction and recognises that development is necessarily risky and b) the donor can show that risks have been assessed, managed and weighed against expected benefits.

FIDUCIARY RISKS AND SUGGESTED SAFEGUARDS

This annex provides summary guidance on short term and longer term measures to manage fiduciary risk and improve standards of public financial management and accountability. It does not represent a complete inventory of problems or remedies. Other published material¹ provides more in depth analysis of public finance issues and reform approaches. Diagnosis and advice on appropriate safeguards to use in a particular country context should be based on detailed diagnostic exercises, such as a CFAA or a fiscal ROSC.

Note also that there is not a simple one to one relationship between the weaknesses and long term solutions. Generic solutions, such as training, procedures development and automation of processes address more than one of the identified weaknesses.

PROCESS: Desirable characteristics:		COMMON WEAKNESSES	LIKELY IMPACT	TEMPORARY SAFEGUARDS	LONG TERM SOLUTIONS
I BUDGET FORMULATION:					
A clear set of rules governs the budget process	Budget management responsibilities are diffuse or unclear	Unrealistic budget, which fails to reconcile policy objectives and available resources.	Earmark DFID funds to priority sector(s) or sub-sector(s) which contribute to poverty reduction	Enact a budget law which clearly defines role and responsibilities of different institutions	Improved annual budget guidelines, timetable and standing procedures on budget preparation.
The budget is comprehensive	Significant revenues and expenditures are not captured in the budget, e.g. donor funds, user charges and tax expenditures.	Inability to stick to expenditure plans and priorities as set out in the budget.	Government undertakings to protect priority spending areas from budget cuts.	Strengthen role of Ministry of Finance in budget co-ordination.	Integrate development and recurrent budget processes
	Executive arm of government not fully accountable for its stewardship of public funds.			Donors report planned expenditure to government.	Capture non –tax revenues and other quasi-fiscal activities in the budget.

¹ Understanding and Reforming Public Expenditure Management (DFID April 2001), Public Expenditure Management Handbook (World Bank 1998), Guidelines for Public Expenditure Management (IMF 1999).

LONG TERM SOLUTIONS

TEMPORARY SAFEGUARDS

LIKELY IMPACT

COMMON WEAKNESSES

PROCESS:

Desirable characteristics:

The budget supports pro-poor strategies	Institutional links between policy, planning and budgeting processes are weak. Inappropriate budget classification which makes it hard to link resources to policy objectives	Expenditure is likely to be poorly targeted resulting in failure to meet policy objectives. Difficult to assess budget effectiveness In reducing poverty	“Virtual” poverty fund, i.e. limited classification system that identifies and tags poverty reducing expenditures. Review of expenditure priorities linked to poverty reduction strategy.	Implement medium term planning and budget process which links resource allocation to policy objectives (MTEF). Introduce a budget classification system that facilitates a programmatic approach.
The budget is a reliable guide to actual expenditure.	Poor-estimation of revenues Poorly costed policies and programmes	Inability to implement the budget as planned and expenditure cuts in year, which tend to have a disproportionate impact on service delivery.	Prudent approach to revenue estimation. Release of DFID funds proportionate to release of government funds as per the budget. (Note this may exacerbate cash flow problems and poor predictability)	Provide technical assistance to: <ul style="list-style-type: none"> • strengthen the revenue forecasting function • strengthen planning and budgeting capacity in spending departments.

II BUDGET EXECUTION

Expenditure within year is controlled	In year financial reporting is late and/or inaccurate	Increased risk of mismanagement leading to failure to meet objectives.	Provision of externally financed professionals to strengthen government accounting and reporting.	Develop and apply accounting procedures Recruit and/or train finance staff to match requirements.
Failure to adhere to budget discipline through overspending or viring of funds	Unfunded liabilities which have to be met from the next year’s budget or by reducing service delivery Failure to meet policy objectives	Control and monitoring of commitments and arrears Centralise control over payments	Reform pay and conditions in order to attract and retain key finance and IT staff. Strengthen internal audit function. Monitor and enforce compliance with financial instructions.	

Release of funds from treasury to spending units is unpredictable.	Adverse impact on the availability and quality of public services	Modify donor disbursement profile to help smooth out uneven government cash flow.	Strengthen capacities for revenue estimation and cash management.
Idle cash balances, which benefit banks at the expense of government.	Credibility of the budget is undermined	Monitor cash balances and reduce rate of disbursement if funds are not being used.	Improve/introduce cash flow forecasting
Corrupt procurement practices	Reduction in resources available for service delivery.	Misuse of public funds threatens the case for budget support.	Rationalise bank account structure
Government carries out procurement in line with principles of value for money and transparency.	Failure to meet service delivery objectives.	Independent value for money review of major tenders.	Introduce transparent and appropriate procurement processes.
Poorly managed procurement	Risk of overspending being uncontrolled leading to unplanned and arbitrary cuts in public expenditure, which tend to have a disproportionate impact on service delivery.	Introduce improved manual reporting procedures, supported if necessary by external help	Removal of political influence from the procurement process.
Failure to reconcile fiscal and bank records	Uncertainty whether or not funds have been used effectively.	External assistance to help government prepare accounts and clear backlogs in key spending departments	Build capacity.
Reporting of expenditure is timely and accurate	Late or non-existent in-year financial reporting	External assistance to help government prepare accounts and clear backlogs in key spending departments	Automate government accounting systems.
Final audited accounts are late.	Uncertainty whether or not funds have been used for the intended purposes	Increased risk that mismanagement and fraud remain undetected	Recruit and/or train finance staff to match requirements.
Basic accounting records are not accurately maintained			Reform pay and conditions in order to attract and retain key finance and IT staff.
			Monitor and enforce compliance with financial instructions
			Develop and apply accounting procedures

PROCESS:
Desirable characteristics:

COMMON WEAKNESSES	LIKELY IMPACT	TEMPORARY SAFEGUARDS	LONG TERM SOLUTIONS
Accounting standards are not defined or applied inconsistently.	Accounts are unreliable or misleading.		Define government accounting policies
Expenditure reporting does not provide information about outputs or outcomes	Problems assessing impact of expenditures and targeting future expenditures on poverty reduction	Expenditure tracking surveys	Revise account code structures to support programmatic approach to budgeting and reporting
Supreme audit institution is either not resourced or not empowered to conduct effective scrutiny.	Government is not held to account for its stewardship of public funds. Increased risk of mismanagement and fraud	Additional independent audit of government spending funded by donors.	Strengthening capacity and independence of supreme audit institution. Put in place effective sanctions to deal with cases of mismanagement and fraud.
The budget is presented in a form which makes it inaccessible to non-experts	No pressure for improvement in the quality of public expenditure	Expenditure tracking studies report on effectiveness of government expenditure.	National Assembly/Parliament asserts its independence
Legislature is not resourced or trained to carry out effective scrutiny of government expenditures.	Quality and quantity public of service delivery stagnates or declines.	NGOs/CSOs substitute for parliamentary scrutiny	Train parliamentarians
Enforcement and follow up of recommendations are ineffective.		Donor scrutiny of public accounts and pressure on government to act on audit report findings	

III INDEPENDENT OVERSIGHT

There is effective independent scrutiny of government expenditure

DEPARTMENT FOR INTERNATIONAL DEVELOPMENT

The Department for International Development (DFID) is the UK government department responsible for promoting development and the reduction of poverty. The government first elected in 1997 has increased its commitment to development by strengthening the department and increasing its budget.

The central focus of the Government's policy, set out in the 1997 White Paper on International Development, is a commitment to the internationally agreed target to halve the proportion of people living in extreme poverty by 2015, together with the associated targets including basic health care provision and universal access to primary education by the same date. The second White Paper on International Development, published in December 2000, reaffirmed this commitment, while focusing specifically on how to manage the process of globalisation to benefit poor people.

DFID seeks to work in partnership with governments which are committed to the international targets, and seeks to work with business, civil society and the research community to this end. We also work with multilateral institutions including the World Bank, United Nations agencies and the European Community.

The bulk of our assistance is concentrated on the poorest countries in Asia and sub-Saharan Africa. We are also contributing to poverty elimination and sustainable development in middle income countries in Latin America, the Caribbean and elsewhere. DFID is also helping the transition countries in central and eastern Europe to try to ensure that the process of change brings benefits to all people and particularly to the poorest.

As well as its headquarters in London and East Kilbride, DFID has offices in many developing countries. In others, DFID works through staff based in British embassies and high commissions.

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