CIPFA

Stocktake on Donor Approaches to Managing Risk when Using Country Systems

Report

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Jeremy Cant (CIPFA)
Rebecca Carter and
Stephen Lister (Mokoro)

Mokoro

CIPFA
3 Robert Street
London
WC2N 6RL
UK

Tel: +44 20 7543 5600
Fax: +44 20 7543 5700

Website: www.cipfa.org.uk

Mokoro Ltd
87 London Rd
Headington, Oxford
OX3 9AA
UK

Tel: +44 1865 741241
Fax: +44 1865 764223
Email: mokoro@mokoro.co.uk
Website: www.mokoro.co.uk

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As a separate exercise the DAC Network on Governance (GOVNET) is undertaking a survey of governance assessments. The survey is a useful complement to this stocktake. The GOVNET survey can be accessed from: http://www.oecd.org/document/14/0,3343,en_2649_34565_39869902_1_1_1_1,00.html

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Acronyms and Abbreviations

AsDB	Asian Development Bank
AAP	Assessment and Action Plan (IMF/WB)
CIDA	Canadian International Development Agency
CFAA	Country Financial Accountability Assessment (World Bank)
CIPFA	Chartered Institute of Public Finance and Accountancy
CPIA	Country Policy and Institutional Assessment (World Bank)
CPAR	Country Procurement Assessment Report (World Bank)
DAC	Development Assistance Committee (of the OECD)
DFID	Department for International Development (UK)
EC	European Commission
GACAP	Governance and Anti-Corruption Action Plan (AsDB)
GBS	General Budget Support
IMF	International Monetary Fund
JFA	Joint Financing Arrangement
JV-PFM	Joint Venture on Public Financial Management (DAC)
MDG	Millennium Development Goal
MOU	Memorandum of Understanding
MTEF	Medium-term Expenditure Framework
OECD	Organisation for Economic Co-operation and Development
PAF	Performance Assistance Framework
PAP	Programme Aid Partners (Mozambique)
PBA	Programme-based Approach
PD	Paris Declaration
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
SAI	Supreme Audit Institution
SBS	Sector Budget Support
SGACA	Strategic Governance and Corruption Assessment (The Netherlands)
Sida	Swedish International Development Agency
SPA	Strategic Partnership with Africa
STR	Sector Track Record (The Netherlands)
SWAp	Sector-wide Approach
TR	Track Record (The Netherlands)
UK	United Kingdom
US	United States

Executive Summary

Study scope and objectives[1]

1. All development cooperation requires risks to be taken. This study focuses on the particular risks and associated development benefits of using country systems to deliver aid. Against the background of their Paris Declaration commitments, this stocktake aims to:

   help donors to identify opportunities to strengthen and harmonise their reliance on country systems within the parameters set by different accountabilities which donors face. This could in turn support a range of donor objectives which include:
   - reducing costs for donors and partner governments;
   - improving the consistency and effectiveness of risk management;
   - facilitating improvements in aid effectiveness;
   - increasing the proportion of donor support provided through country systems. (from TOR)

2. This draft of the study is based on a factual review of the policies and guidelines of 9 donors (bilaterals: Canada, France, Germany, the Netherlands, Sweden, the UK; multilaterals: the Asian Development Bank, the European Commission, and the World Bank). All the findings so far are based on this limited sample of donors. Moreover, it is based on the documentation itself, as it was beyond the study's scope to verify guidelines against practice in the field.

3. The report provides a detailed review of similarities and differences between the sample donors in:
   - their policies and guidelines for the use of country systems, and the benefits they recognise from using country systems;
   - their approaches to each aspect of risk management: identifying risks, initial risk assessment and subsequent monitoring, and strategies for addressing risks.

4. The study reviewed a range of financial and non-financial risks that donors recognise.[2] These include financial management risks, fiduciary risks including corruption, other governance risks, developmental risks, risks to partnership and dialogue, and related risks to the donor's reputation. (Different donors define and group these risks in different ways.)

5. The report itself systematically compares the similarities and differences among the sampled donors for each phase of risk management. Additional comparative tables are provided as annexes to the main report. For each of the donors reviewed, the evidence base has been assembled as a standard Analytical Framework which documents the donor's policies and guidelines as they relate to the use of country systems and the management of associated risks. The Analytical Frameworks are separate documents and are not published as part of this report.

6. This summary focuses on the main features of risk management in using country systems that were apparent from the stocktaking exercise, and on the main issues and opportunities for donors that emerge from it.

[1] The study was commissioned by DFID on behalf of the OECD DAC Joint Venture on Public Financial Management (JV-PFM).

[2] But the procurement risks of using country systems were excluded from the study's scope.

Risk factors in implementing the PD commitments on country systems

7. Although risk management is an increasingly recognised field, the risk issues that relate to aid and the use of country systems are exceptionally complex. Thus different donors may have different perceptions of the benefits of using country systems, as well as different perceptions of the risks involved. Risk perceptions and preferences are linked to the specific accountabilities and constraints on individual donors as well as to the "objective" performance of country systems. The overall assessment of risk requires very different types of risk (financial, political, reputational) to be taken into account, and, although donors take independent decisions, their separate actions have effects on overall benefits and risks. Moreover, neither country systems nor donor organisations are homogenous. There may be different risks attached to using different elements of country systems, and risk perceptions and preferences may be different at different levels within a donor organisation.

8. The Paris Declaration (PD) commitments are not limited to (and do not insist on) the use of budget support. As the various PD indicators and targets make clear, the undertakings to maximise the use of government systems apply to all official development assistance to the government sector, and the PD gives specific encouragement to the use of programme-based approaches (PBAs) in general.[3] Country systems have many dimensions (e.g. planning, budgeting, financial disbursement, procurement, accounting), so the partial use of country systems is an option. The use of country systems is thus a matter of design of specific instruments as well as choice of broad modalities.

9. All donors reviewed have an explicit policy and guidelines in favour of the use of country systems. At the same time, the PD 2006 monitoring survey reveals a wide range of donor performance in using country systems. Although different perceptions of risk are one likely explanation, there is no simple correlation between use of country systems and standard assessments of PFM quality.

10. There are strong similarities in the categories of risk that donors recognise, although there are slight differences in where boundaries are drawn (e.g. whether corruption is considered more as an element of financial/fiduciary risk or as part of governance). For most donors, financial risks are more tightly defined than other recognised risks. Although the commitment to use country systems is not limited to budget support modalities, there is a tendency for risks and benefits of country systems to be more explicitly discussed when budget support is being considered.

11. The rationale for using country systems has been largely built on the observed disbenefits when aid bypasses country systems. However, many risks are seen as short term and donor-specific, while the benefits of strengthening country systems tend to be longer term and more general. This may explain why donors do not generally link specific risks to specific benefits of using country systems.

[3] Programme-Based Approaches (PBAs) are a way of engaging in development cooperation based on the principles of co-ordinated support for a locally owned programme of development, such as a national development strategy, a sector programme, a thematic programme or a programme of a specific organisation. Programme-based approaches share all four of the following features: (a) leadership by the host country or organisation; (b) a single comprehensive programme and budget framework; (c) a formalised process for donor co-ordination and harmonisation of donor procedures for reporting, budgeting, financial management and procurement; (d) efforts to increase the use of local systems for programme design and implementation, financial management, monitoring and evaluation. (OECD DAC definition)

Broad findings and possible follow-up

12. Throughout the report, observations of commonalities and differences in donor approaches are highlighted and these have informed the identification of opportunities for donors to increase harmonisation and coordination of efforts as a step towards the greater use of country systems.

13. The stocktake reveals a surge in the number and the breadth of various assessments being undertaken by donors in connection with efforts to follow up the PD commitments on using country systems. However, the picture revealed by this stocktake suggests some potential concerns, as follows:
    (a) **The configuration of risks and benefits associated with using country systems is such that donors are likely to experience a built-in bias against the use of country systems in practice**. Decisions at operational level are likely to be more risk-averse than the strategic policy guidance of donor headquarters would suggest. (The World Bank, for example, acknowledges that its standard of "equivalence" with Bank systems sets the bar very high.)
    (b) **There is potential for high transactions costs and inefficiency in the number of separate, and often uncoordinated, assessments now being undertaken.** There is also a risk of bypassing country stakeholders in the conduct of such assessments. (Examples: the number of slightly different ways in which donors are drawing on PEFA reports as part of financial risk assessments; the profusion of governance assessments, many of which draw largely on the same secondary sources.)
    (c) **The safeguards and other mitigating strategies adopted in conjunction with the greater use of country systems may undermine the benefits derived from using country systems.** (Examples: the possible multiplication of conditions as each donor seeks to mitigate the risks it faces; the risk that the costs of hybrid financial management systems may exceed the benefits.)

14. However, for all of these concerns there are corresponding opportunities, both for individual donors and for donors working collaboratively. Thus:
    (a) **Donors can review the consistency in their policies and practices on addressing risk** at different levels of the organisation and seek to rectify unintentional biases against the use of country systems. In the light of the Paris Declaration, the onus should be to justify the non-use of country systems.
    (b) There is scope for **more collaboration on many of the reviews and assessments that donors require**. The PEFA experience provides a pattern that shows it may be possible to agree on a transparent assessment that different users can feed into their separate decision-making processes. At various points we have observed that there may be scope for collaboration in standardising terminology and developing assessment methodologies and assessment tools concerning fiduciary risks, corruption, and other aspects of governance. It is important to **involve partner governments and other partner country stakeholders in these efforts.**
    (c) There is also scope for **joint learning concerning the better design of aid instruments that use country systems**, and in using different aid instruments (e.g. general and sector budget support) in ways that reduce and spread risks.
    (d) There is scope for **donors to collaborate also in the delivery of aid through country systems, in ways that reduce the risks that each donor faces and at the same time seek to combine forces in strengthening country systems** (e.g. in supporting capacity building, and harmonising so as to avoid the multiplication of separate donor conditions and safeguards).

1. Introduction

Background

1.1 Use of country systems is a major focus of the Paris Declaration to improve aid effectiveness, with the ultimate aim of accelerating poverty reduction.

1.2 All development cooperation requires risks to be taken. This study focuses on the particular risks and associated development benefits of using country systems. Donors vary significantly in how they define, assess, manage and monitor risks and how they identify and assess benefits. The variation in donor approaches to risks and benefits associated with using country systems can lead to extra transaction costs (for donors and partner governments), to inconsistencies in risk management, and to the undermining of efforts to increase the use of country systems and thereby improve aid effectiveness and reduce poverty.

1.3 This study, and resulting report, was commissioned by DFID on behalf of the OECD DAC Joint Venture on Public Financial Management (JV-PFM). The results of the study are to feed into the paper on 'Use of Country Systems' that the Joint Venture is producing for the Accra High-Level Forum on Aid Effectiveness in September 2008.

Study objective

1.4 The TOR (in full at Annex A) specifies a 'Stocktake' report which:

- identifies, analyses and records, in summary form, donor approaches to defining, assessing, managing and monitoring risks when using country systems;
- identifies the range of benefits from using country systems which are recognised and measured by donors; and
- identifies the different types of relationships between risks and benefits recognised by donors.

1.5 The objective of the report, as described in the TOR, is to:

> help donors to identify opportunities to strengthen and harmonise their reliance on country systems within the parameters set by different accountabilities which donors face. This could in turn support a range of donor objectives which include:
>
> i) reducing costs for donors and partner governments;
> ii) improving the consistency and effectiveness of risk management;
> iii) facilitating improvements in aid effectiveness;
> iv) increasing the proportion of donor support provided through country systems.

Scope and process

1.6 The stocktake analysed the policies and guidelines of the bilateral agencies of Canada, France, Germany, the Netherlands, Sweden and the UK plus the Asian Development Bank, European Commission and the World Bank.[4] These donors volunteered to be included in this stocktake. At their own request, Japan and the United States were not included in this study.

[4] For readability, 'donors' will be used to refer to bilateral donors and international organisations providing development financing, concessional and non-concessional.

1.7 The study process was to gather information from the relevant donors and produce a series of Analytical Frameworks describing each donor's policies and procedures as they relate to the use of country systems in aid delivery. The respective donors were asked to check their analytical frameworks, and the consultants are grateful for the detailed feedback received from Agence Française de Développement, the Asian Development Bank, CIDA, DFID, the EC, KfW, the Netherlands, and Sida. The stocktake is based on the policy documentation and guidelines. It was beyond the study scope to check how these are actually implemented in the field. In several cases, guidelines have been recently revised, and are therefore ahead of practice in the field.

1.8 The findings of the draft report were presented to the JV-PFM on 13th March. The report was then revised in the light of comments received. In addition information from Sida and AsDB was incorporated, adding to the group of donors covered by the stocktake.

Challenges and approach

1.9 Although risk management is an increasingly recognised field, the risk issues that relate to aid and the use of country systems are exceptionally complex. Thus different donors may have different perceptions of the benefits of using country systems, as well as different perceptions of the risks involved. Risk perceptions and preferences are linked to the specific accountabilities and constraints on individual donors as well as to the "objective" performance of country systems. The overall assessment of risk requires very different types of risk (financial, political, reputational) to be taken into account, and, although donors take independent decisions, their separate actions have effects on overall benefits and risks. Moreover, neither country systems not donor organisations are homogeneous. There may be different risks attached to using different elements of country systems and different ministries, departments or agencies, while risk perceptions and preferences may be different at different levels within a donor organisation.

1.10 This report was commissioned as a factual stocktake, and does not prescribe particular approaches to risk analysis and management. However, an analytical framework is needed in order to give the report a useful structure and serve the study objectives (¶1.5 above). Hence the report is organised as follows:

- Chapter 2 reviews international commitments to the use of country systems, as reflected in the Paris Declaration, and the underlying rationale for the use of country systems.
- Chapter 3 surveys donors' broad policies and guidelines on the use of country systems, including donors' perceptions of the benefits, and how donors assess benefits in balancing them against risks.
- Chapter 4 provides a methodological framework for the rest of the report; it provides a typology of the different financial and non-financial risks donors may consider and presents a risk management model which enables the complex relationships to be viewed systematically.
- Chapter 5 surveys the way different donors define the risks of using country systems.
- Chapter 6 describes donor policies and procedures for assessing these various risks.
- Chapter 7 describes how donors address and manage the risks they identify.
- Chapter 8 describes how donors respond to breaches and 'crises'.
- Finally, Chapter 9 suggests possible lessons and follow-up from this stocktake.

2. International Commitments to the Use of Country Systems

Introduction

2.1 This chapter

- notes the relevant Paris Declaration (PD) commitments, and the baseline figures on use of country systems from the first PD monitoring survey;
- highlights the different dimensions of country systems, and hence the scope for full or partial use of country systems by different aid modalities;
- notes the rationale for use of country systems that underlies the PD commitments.

The Paris Declaration and use of country systems

The Paris Declaration commitments

2.2 In the Paris Declaration, donors undertook to use country systems and procedures to the maximum extent possible and where this is not feasible, to establish additional safeguards and measures in ways that strengthen rather than undermine country systems and procedures. (This concern explicitly extends also to fragile states.) Box 2.1 highlights relevant PD commitments under the headings of alignment and harmonisation.

2.3 Although the principle of alignment relates more directly to the use of country systems, the Paris Declaration's partnership principle of harmonisation is also relevant to donors' analysis of risk and their reactions to it. In this respect, donors committed to:

- implement, where feasible, common arrangements at country level for planning, funding, disbursement, evaluating and reporting to government on donor activities and aid flows;
- work together to reduce the number of separate, duplicative, missions to the field and diagnostic reviews;
- work together to harmonise separate procedures.

Different modalities and different elements of country systems

2.4 The Paris Declaration commitments are not limited to (and do not insist on) the use of budget support. As the various PD indicators and targets make clear, the undertakings to maximise the use of government systems apply to all official development assistance to the government sector. The PD does encourage (and set targets for) greater use of programme-based approaches (PBAs), which it defined as:

> A way of engaging in development cooperation based on the principles of co-ordinated support for a locally owned programme of development, such as a national development strategy, a sector programme, a thematic programme or a programme of a specific organisation. Programme based approaches share the following features: (a) leadership by the host country or organisation; (b) a single comprehensive programme and budget framework; (c) a formalised process for donor co-ordination and harmonisation of donor procedures for reporting, budgeting, financial management and procurement; (d) **Efforts to increase the use of local systems for programme design and implementation, financial management, monitoring and evaluation**. (High Level Forum, 2005; emphasis added).

Box 2.1: Paris Declaration commitments on alignment and harmonisation

Alignment

Donors align with partners' strategies

(16) *Donors commit to:*

- Base their overall support — country strategies, policy dialogues and development co-operation programmes — on partners' national development strategies and periodic reviews of progress in implementing these strategies. (Indicator 3).

Donors use strengthened country systems

(21) *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.
- Avoid, to the maximum extent possible, creating dedicated structures for day-to-day management and implementation of aid-financed projects and programmes.

Strengthen public financial management capacity

(25) *Partners commit to:*

- Publish timely, transparent and reliable reporting on budget execution.

(26) *Donors commit to:*

- Provide reliable indicative commitments of aid over a multi-year framework and disburse aid in a timely and predictable fashion according to agreed schedules.
- Rely to the maximum extent possible on transparent partner government budget and accounting mechanisms.

(27) *Partner countries and donors commit to:*

- Implement harmonised diagnostic reviews and performance assessment frameworks in public financial management.

Harmonisation

Donors implement common arrangements and simplify procedures

(32) *Donors commit to:*

- Implement, where feasible, common arrangements at country level for planning, funding (e.g. joint financial arrangements), disbursement, monitoring, evaluating and reporting to government on donor activities and aid flows. Increased use of programme-based aid modalities can contribute to this effect.

Deliver effective aid in fragile states

(39) *Donors commit to:*

- Avoid activities that undermine national institution building, such as bypassing national budget processes or setting high salaries for local staff.

Source: High Level Forum, 2005.

2.5 Thus PBAs are oriented towards the use of country systems. PBAs can be implemented through a range of aid modalities, including general and sector budget support.[5] The use of country systems in other PBA variants may be less complete. Box 2.2 illustrates some different dimensions of country budget systems, and highlights the point that use of country systems is not an all-or-nothing choice when aid instruments are being designed. Equally, perceived risks may be greater in some components of the country system than others.

[5] The PD monitoring survey indicator on support to PBAs tracks both direct budget support and other assistance provided in support of PBAs.

Box 2.2: Different dimensions of country budget systems

Term	Definition
On plan	Programme and project aid spending is integrated into spending agencies' strategic planning and supporting documentation for policy intentions behind the budget submissions.
On budget	External financing, including programme and project financing, and its intended use are reported in the budget documentation.
On parliament	External financing is included in the revenue and appropriations approved by parliament.
On treasury	External financing is disbursed into the main revenue funds of government and managed through government's systems.
On procurement[6]	Externally-financed procurement follows the government's standard procurement procedures.
On accounting	External financing is recorded and accounted for in the government's accounting system, in line with the government's classification system.
On audit	External financing is audited by the government's auditing system.
On report	External financing is included in ex post reports by government. (These ex-post reports include: government's annual financial statements and associated reports as well as programme reports which summarise spend on programmes and projects).

***Source**:* Aid On Budget Study (Mokoro Ltd, 2008b).

Baseline figures on the use of country systems

2.6 The Paris Declaration includes indicators and targets for its implementation. The PD Monitoring Survey in 2006 has attempted to establish baseline performance levels against which progress can be gauged. Several of the indicators relate to different aspects of the use of country systems. Table 2.1 summarises donor scores against these indicators. It covers all the donors who participate in the JV-PFM. Donors are listed from left (room for improvement) to right (better performers) for their unweighted country average on each indicator.

2.7 Too much should not be read into this initial survey. (The survey report (OECD, 2007) explains several caveats, which are summarised in Annex C.) However, it does demonstrate that:

- there is some way to go to meet the PD targets on use of country systems;
- there is wide range of donor behaviour concerning the use of country systems.

2.8 All major donors have signed up to the Paris Declaration. Although there is no overt dissent from the consensus that the use of country systems is desirable, there are differences among donors in their views as to the minimum quality of partner country PFM system that is acceptable for use in delivering aid. Thus the differential treatment of financial risk is likely to be one of the explanations for the differences in donor performance that are apparent in Table 2.1. However, as the PD 2006 Survey observed, there is not a simple correlation between the standards of a country's PFM system (as indicated by the relevant World Bank CPIA rating) and the proportion of aid to the government sector that is delivered through government systems.[7]

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[6] Procurement is not included within the scope of this risk stocktaking study. (Social and environmental safeguards are also beyond its scope.)

[7] Donors tend to justify their bypassing of country PFM and procurement systems by pointing to weaknesses in those systems that make them unreliable. This is quite plausible. For this reason, the agreed Paris Declaration targets for utilisation of country PFM and procurement systems are conditional upon the

The aid effectiveness rationale for using country systems

2.9 The Paris Declaration stated that:

> Using a country's institutions and systems, where these provide assurance that aid will be used for agreed purposes, increases aid effectiveness by strengthening the partner country's sustainable capacity to develop, implement and account for its policies to its citizens and parliament. (High Level Forum, 2005: ¶17)

2.10 The case for using country systems is principally supported by negative experiences with aid that deliberately bypassed country systems. A series of evaluations and assessments found that conditionality was not successful in imposing reforms on an unwilling government, and that parallel project implementation modalities rarely led to sustainable developments; they also tended to debilitate government systems and their capacity by drawing away staff and resources, and by fragmenting the process of planning and budgeting. There has also been growing recognition that using donor procedures does not automatically ensure a corruption-free project. As summarised by the Asian Development Bank:

> Donor-required project procedures commonly reduce risk of corruption. However, short-term project structures also create new incentives for abuse, especially where large funds are concerned, and new lines of accountability and patronage are created. It can not be assumed, therefore, that AsDB financial and procurement systems (or those of other donors in the sector) are succeeding in reducing corruption; this must be assessed. (AsDB, 2008: 8)

2.11 This background has some corollaries that may be important in considering the influence of risk (and benefit) assessments on the use of country systems:

- It may be hard to articulate the benefits of using country systems in detail, if the principal benefit is the avoidance of harm. This is especially true when the disbenefits of not using country systems are long term (failure to sustain parallel projects), and cumulative (how much difference does one parallel project make?).
- There is potentially a collective action problem, since the costs of bypassing country systems are not fully or immediately felt by the donor concerned.
- These problems may be exacerbated to the extent that perceived risks (notably financial risks, but also possible costs in delay etc) are short-term and donor-specific, while the benefits of using country systems are long-term and diffuse.

systems attaining a certain level of reliability. However, according to the PD 2006 Survey results, the index of country system usage varies enormously between donors, and is not correlated at all with the best measure we have of the quality of those systems, the World Bank's CPIA rating for budget and financial management. (ODI, 2008: 21)

Table 2.1: Paris Declaration 2006 Survey – findings on donors' use of country systems

Room for improvement → **Better performers**

3. Aid flows aligned	Total BR + CA		Portugal	Italy	Australia	Japan	United States	Finland	Sweden	Spain	Belgium	France	Netherlands	UK	Denmark	Ireland	Germany	Canada	EC	Norway	New Zealand	AfDB	AsDB	World Bank
Government budget estimates of aid flows as % of aid disbursed for the government sector	88%	*BR*	24%	36%	36%	68%	90%	87%	49%	87%	44%	52%	70%	84%	47%	48%	55%	75%	81%	56%	40%	95%	88%	94%
	42%	*DCA*	15%	16%	29%	30%	30%	32%	35%	41%	42%	43%	44%	45%	47%	48%	50%	51%	56%	57%	58%	59%	62%	62%

5a. Use of country PFM systems	Total BR + CA		Australia	United States	Japan	Spain	Denmark	France	AfDB	Germany	Belgium	Finland	New Zealand	Canada	World Bank	Italy	EC	Sweden	UK	Portugal	Norway	AsDB	Netherlands	Ireland
% aid flows disbursed for government sector that use national PFM systems	40%	*BR*	6%	10%	29%	16%	29%	28%	33%	35%	24%	38%	10%	42%	42%	29%	40%	47%	75%	79%	61%	69%	71%	90%
	33%	*DCA*	6%	15%	16%	21%	27%	28%	28%	28%	29%	30%	34%	35%	36%	38%	38%	40%	53%	54%	56%	56%	60%	90%

5b. Use of country procurement systems	Total BR + CA		Australia	United States	Japan	Spain	World Bank	AfDB	AsDB	Germany	New Zealand	Canada	EC	Sweden	Finland	Denmark	Italy	UK	France	Portugal	Belgium	Norway	Netherlands	Ireland
% of aid for the government sectors that uses country procurement systems	40%	*BR*	5%	12%	26%	14%	40%	43%	45%	34%	14%	45%	41%	48%	52%	45%	50%	76%	60%	80%	43%	69%	78%	96%
	30%	*DCA*	10%	11%	14%	23%	30%	32%	35%	35%	36%	39%	40%	42%	43%	46%	49%	51%	52%	54%	54%	66%	72%	95%

Room for improvement → **Better performers**

	Total + CA		AfDB	United States	World Bank	AsDB	Spain	EC	Australia	Belgium	Denmark	Canada	France	Italy	UK	Sweden	Germany	Ireland	Netherlands	Finland	Portugal	Norway	Japan	New Zealand
6. Avoid parallel implementation structures																								
how many PIUs are parallel to country structures	1,832	*total*	132	208	223	39	66	204	27	67	69	68	63	30	41	36	40	6	23	9	1	3	2	0
	61	*DCA*	8	7.2	7	6.5	6.0	6	5.4	4.2	3.8	3.1	2.4	2.3	1.8	1.5	1.3	1.0	1	0.8	0.5	0.2	0.1	0.0

	Total BR + CA		Portugal	New Zealand	Spain	United States	France	Germany	Italy	Japan	AsDB	Australia	Belgium	Canada	Norway	AfDB	Sweden	Finland	World Bank	EC	UK	Denmark	Ireland	Netherlands
9. Use of common arrangements or procedures																								
Total aid towards PBAs as % of total aid disbursed	43%	*BR*	4%	6%	14%	28%	28%	20%	40%	33%	23%	29%	32%	51%	36%	40%	47%	39%	57%	50%	59%	60%	64%	68%
	35%	*DCA*	6%	8%	14%	16%	19%	23%	25%	26%	27%	28%	32%	33%	34%	37%	38%	40%	44%	45%	50%	58%	59%	61%

***Notes*:**

BR = Baseline Ratio. The baseline ratio is a weighted average, based on each donor's portfolio in the surveyed countries. It is the Paris Declaration survey result for the base year of 2005. It is the aggregate value of the numerator divided by the aggregate value of the denominator; i.e. each country is weighted by the volume of activity.

DCA = Donor country average. An unweighted average. It provides a comparative measure of the baseline irrespective of the volume of activity in each country; i.e. it gives equal weight to each country.

CA = Country average. This is the unweighted average of performance by country, not the average of donor performance.

Donor data coverage: Each donor will have a different profile in the countries included in the Survey; consequently the dataset covers different proportions of each donor's global aid programme. (For example, Information for the African Development Bank covers data reported in 17 countries out of 34 and reflects 74% of country programmed aid in 2005 while Information for New Zealand covers data reported in 3 countries out of 34 and reflects 5% of country programmed aid in 2005.)

***Source*:** OECD, 2007.

3. Donor Guidelines on Country Systems and their Benefits

Introduction

3.1 This chapter

- surveys donors' general policy guidelines on the use of country systems;
- reviews their perceptions of the benefits of using country systems; and
- notes how the benefits of using country systems are factored into donors' overall assessment of benefits and risks.

Donor policies on the use of country systems

General policy guidelines

3.2 Our review of individual donors' policies confirmed that each donor is committed to using country PFM systems wherever possible. Their general policy statements typically echo the Paris Declaration. The World Bank has neatly summed up this position:

> The use of country systems has significant potential to improve development impact. Development can be successful only if the country itself owns the process and the government leads development efforts. (World Bank, 2007b)

3.3 Where it is not feasible to use partner country systems, the Paris Declaration requires donors to establish any additional safeguards and measures in ways that strengthen rather than undermine country systems and procedures. Again, each of the donors has endorsed this in their respective policy positions. In the United Kingdom, DFID has summed this up:

> Where it is not possible to use country systems, donors should adopt a harmonised approach to the introduction of additional safeguards, ensure that reporting processes are consistent with sectoral and national processes, and support a longer-term strategy to address these constraints and move closer to government systems over time. (DFID, 2006)

3.4 The Paris Declaration recognised that donors can only be expected to use partner country systems if they provide assurance that aid will be used for agreed purposes. In practice, therefore, each donor qualifies its position by stipulating certain eligibility criteria that must be met before partner country systems can be relied upon. These criteria differ according to each donor's interpretation of its accountabilities and its attitude towards risk; their application is covered in Chapter 7.

3.5 Donor policies for using country systems are summarised in Table 3.1 below.

Table 3.1: Donors' policies for using country systems

Bilaterals	
Canada	CIDA's policy statement on Strengthening Aid Effectiveness underlines the principles of local ownership, improved donor coordination, stronger partnerships, a result-based approach and greater policy coherence. CIDA is committed to using programme-based approaches where the conditions exist for their effective use.
France	In countries where fiduciary risk is under control, France will channel aid via partners' PFM systems. Elsewhere, support will go to strengthen the capacities of the PFM system. France will use local procurement systems and partner country's monitoring and auditing procedures as much as possible.
Germany	By subscribing to the Paris Declaration, Germany undertook to use as far as possible the recipient country processes and systems to strengthen them. Budget support will only be considered for countries that fulfil minimum entry criteria in respect of political, fiduciary and macroeconomic risks.

Bilaterals	
Netherlands	Achieving the maximum level of alignment effective within a particular country context is a priority for Dutch development cooperation. The Netherlands supports far-reaching harmonisation and alignment.The general objective is 'programme aid where possible, project aid where necessary'.
Sweden	Sweden is committed to align to partner government procedures and systems, including PFM systems. Sida's default assumption is that government systems shall be used as far as possible. Exceptions from this rule must be substantiated and based on the assessment of risks, the relative trend, and reform efforts planned.
UK	DFID policy is to put aid on budget. Country systems – for planning, budgeting, accounting, audit, procurement and performance management – should be used wherever possible. Where this is not possible, donors should adopt a harmonised approach to the introduction of additional safeguards, ensure that reporting processes are consistent with sectoral and national processes, and support a longer-term strategy to address these constraints and move closer to government systems over time. In deciding whether to use country systems, DFID will determine whether the country has a credible programme to improve its PFM systems.
Multilaterals	
AsDB	The AsDB is committed to work closely with its development partners and to formulate new mechanisms and instruments of doing so. In this context the ADB specifically identifies sector-wide approaches (SWAp), and in particular budget support, as a means of making use of country systems, and commits itself to increase the use of these types of approaches to delivering aid. Such approaches can be undertaken as institutional and policy frameworks improve in a sector and reporting and monitoring mechanisms are put in place. AsDB policy is that "a more flexible approach is required to meet the needs of such weakly performing countries. This will include not only special fields and modalities of intervention and allocation of resources, but also special forms of partnership with the government and development partners [and] flexibility in the application of policies and procedures…"
EC	The EC is committed to implementing the Paris Declaration. Beyond this, the EC has pledged to channel 50% of government-to-government assistance through country systems. It is EC policy to use general and sector budget support as the financial modality for its assistance whenever conditions are favourable. Budget support is only programmed in countries which have in place or are developing: (i) a poverty reduction strategy; (ii) a stability oriented macroeconomic policy; and (iii) a credible programme to improve PFM.
World Bank	The Bank's policies permit the use of country systems where these are assessed by the Bank as being adequate (equivalent to Bank systems). Subject to the incorporation of capacity strengthening measures as needed, the default position is that existing PFM institutional frameworks are used for the purposes of Bank supported operations. [In addition, the Bank's Development Policy Lending (budget support) uses country systems on less stringent criteria. See eligibility criteria table in Chapter 7 (Table 7.2)]

Source: individual donor policies and guidelines – see Annex H for reference list.

3.6 Each donor states a clear policy for using country systems, but not all the donors reviewed have clearly set out their criteria for using country systems in practice. Nor do they set out clearly the level of risk they are prepared to take when using country systems. As a result, their central procedures for managing aid flows might not be consistent with the overall policy of increasing the use of country systems. See discussion in ¶7.8–7.11.

3.7 Donors recognise that using country systems in fragile states can carry additional risks. While the guiding principles of effective aid apply equally to fragile states, they need to be adapted to circumstances of weak ownership and capacity and to immediate needs for basic service delivery. The Netherlands and the United Kingdom appear to be the most enthusiastic for using country systems in fragile states, whereas France and Germany are more cautious. The Netherlands states that:

> A positive track record is not strictly necessary for budget support for fragile states. This type of budget support is by definition a political decision. (DEK, 2007c)

Where the partner country government does not have the capacity to take the lead, both the UK and the EC advocate joint donor programming with 'shadow alignment', which allows donors to work in a way that is compatible with government policies and systems even if they do not work through them.

Donor perceptions of the benefits of using country systems

3.8 Each donor recognises that there are benefits to be had from using country systems. However, donors do not generally give a lot of detail on these expected benefits, rather they are taken as a given. The benefits of using country systems are most often spelt out in connection with general (or sector) budget support. Donors do not tend to list in detail the benefits of using country systems for other aid modalities; for example, the benefits that arise from putting project aid 'on plan' or from putting pooled funding 'on treasury'.

3.9 The commonly recognised benefits are listed in Box 3.1, and Annex B sets out which donors recognise the potential benefits identified by the study team. All of the donors recognise 'improved alignment with partner country policies and systems' as a benefit, but few donors seem to give much prominence to 'sustainability of donor programmes' or 'increasing a country's absorption capacity'.

3.10 It was not possible from the documentation to determine what weight donors attach to the different benefits. Moreover, the documents do not usually distinguish between intermediate benefits (such as alignment) and the ultimate benefits (such as stronger national PFM systems) to which they were expected to lead. Nor do they specify the ultimate benefits in detail (e.g. how PFM performance is expected to improve).

3.11 Where donors identify different benefits of using country systems, they do not rank them in order of importance. This seems a pragmatic approach. Which benefits are more significant will depend on individual country circumstances; also, benefits overlap and interact with one another, so it is not necessarily practical to treat them separately. The EC's approach seems to be typical:

> There are many ways of presenting the potential benefit…..it needs to be recognised that not all potential benefits may arise at the same time, and that any potential benefits will depend on country context. (European Commission, 2007)

Assessment of benefits and balancing against risks

3.12 Donors have traditionally carried out an assessment of the development benefits (or impact) that they expect their country programmes, and individual operations, to deliver. However, these have not generally been carried out in a very systematic way and the benefits identified have not been explicitly linked to the cost of realising the benefit or to the risks involved in delivering it.

Box 3.1: Recognised benefits of using country systems

Policy
- Improved alignment with partner country policies

Systems
- Improved alignment with partner country systems (budget systems and result systems)

Ownership and accountability
- Increased country ownership
- Improved domestic accountability through increased focus on the government's own accountability channels

Strengthening systems
- A more stable macroeconomic framework
- Strengthening of partner country PFM systems
- Higher efficiency of public expenditures

Donorship
- Higher potential for overall impact / (encourages broader dialogue, streamline process of formulating reforms)
- Improved coordination and harmonisation among donors
- Greater predictability of funding
- Sustainability of donor programmes

Transaction costs
- Lower transaction costs for donors
- Lower transaction costs for governments
- Increases a country's absorption capacity

3.13 Canadian and Swedish policies include the principle of systematically comparing benefits against risks:

- CIDA's fiduciary risk policy states that the level of acceptable risk for a PBA initiative will vary according to the extent of expected benefits (e.g. poverty reduction, strengthening of institutions). Ultimately, an assessment should be made as to whether the residual fiduciary risks are acceptable given the expected benefits.
- Sida's public finance management handbook gives advice on how to draw conclusions of the overall positive effects and trade-offs of aligning in a given country and specifies that:

> When assessing whether budget support should be provided to a partner country, therefore, Sweden must weigh the risk of the budget funds being used for purposes other than those intended against the likely benefits that such support would have for public financial management systems. (Sida, 2007)

3.14 Two of the donors covered by the stocktake, the United Kingdom and the EC, have recently introduced more systematic arrangements for assessing benefits (when considering budget support):

DFID guidance on 'Assessing the Potential Benefits of PRBS', issued in January 2008, emphasises the importance of a more extensive and systematic assessment of the benefits as well as the risks. There are three related factors: • the possible benefits that may be achieved by using budget support; • the risks that might undermine these possible benefits; • the design features and complementary actions that could be used to maximise the likelihood that benefits will be realised. Detailed assessment of the benefits of using PRBS should include, for each expected benefit, an indication of the benefits that are possible and what they depend on (e.g. absence of constraints, management of risks). (DFID, 2008b)
For the EC, the decision to use country systems is based on a comparison between the expected benefits and risks for the objectives set out in the Country Strategy Paper. There are two assessments: • value the expected impact: rank the potential contribution of General Budget Support to the objectives of the response strategy [in relation to country programme] from high to low; • assess the partner country's prospective eligibility for budget support and the risk of difficulty during implementation that could result in non-utilisation of budget support resources as strong / potential / weak. In ranking the potential contribution that general budget support can make, the EC has identified the following factors to consider: • the significance of being involved in a dialogue on the overall policy and strategic priorities of the partner country; • the importance of contributing to increased expenditure or the financing of the budget; • the scope and depth of reforms and policies that could be supported with GBS (including those that would be necessary to establish eligibility) • the importance of promoting improvements in public financial management; • the readiness of the partner country in using results/outcome indicators to monitor progress towards its development or reform objectives; • the importance of advancing harmonisation and alignment through the use of the partner country's systems and the participation in joint donor groups. (European Commission, 2007)

3.15 Most donors' guidelines (the Netherlands, Sweden, the UK, the EC, the World Bank) emphasise the importance of checking that any specific safeguards that are proposed do not undermine the intended benefits of using country systems.

Reflections

3.16 Weak articulation of benefits of using country systems may reflect the fact that expected benefits are rather general, and that stronger perceptions (underlying the Paris Declaration) have been of the disbenefits of bypassing country systems. As described in ¶2.11 above, the perception of specific and short-term risks against general and long-term benefits may create a built-in tendency towards the sub-optimal use of country systems. This point is reflected in the risk management model set out in Chapter 3, and further explored in the subsequent chapters of this report.

Key Commonalities	Although expressed in different ways, each donor shares the same broad policy of using country systems wherever possible. In principle, donors' willingness to use country systems depends upon the standard of the country systems and/or the country government's commitment to a programme of reform. (For more on this see Chapter 7.) Donors tend not to spell out in detail the expected benefits of using country systems.

Key Differences	In practice, however, there are differences in the eligibility criteria that different donors apply (see Chapter 7). There are also differences in donors' attitudes towards risk when delivering aid to 'fragile states'. Some donors provide guidelines for more extensive and systematic comparison of benefits and risks of using country systems (but this tends to be a recent development).
Opportunity	Each donor could review its practice, as distinct from its policy, for using country systems, and how it intends to increase its overall alignment. A particular point to check is that the donor's operational guidelines and the incentives facing its operational-level decision makers are consistent with the strategic objectives set by its HQ.[8] The JV-PFM could encourage donors to put the onus more on justifying the non-use of country systems. There is an opportunity to develop greater shared understanding of the benefits of using country systems and cross-learning on experiences of systematic comparisons of benefits and risks when deciding to use country systems.

[8] See Chapter 4, and Figure 4.1, for discussion of the hierarchy of risk management.

4. Relevant Risk Concepts

Introduction

4.1 This stocktake is essentially descriptive, not prescriptive. However, even description requires an analytical framework that allows different donors' approaches to be classified and compared in a meaningful way. This chapter:

- provides a broad typology of the risks donors identify in connection with the use of country systems;
- notes the hierarchy from strategic to operational risk management;
- presents a risk management model which provides a systematic way of looking at the complex relationships involved in risk management and aid delivery;
- notes the key principles in assessing risks; and
- clarifies other terminology used in the rest of this report.

Broad types of risk

4.2 Risks can be categorised in various ways. Table 4.1 below does not attempt to resolve the differences in definition used by different donors, but we found it a useful frame of reference for identifying and comparing the risks recognised by donors.

4.3 There are, inevitably, overlaps between the different types of risk shown. There is a strong literature and tradition dealing with financial risks, which are in many ways more tangible than the other risks identified. For convenience, this report deals with financial risks and then with other risks, under separate headings, but it is important not to lose sight of the overlaps, and the interactions, between financial and other risks.

Table 4.1: Risk typology

Risks		General definition: Risk that…
1. Developmental risks		poverty reduction objectives are not achieved
2. Financial (or fiduciary) risks		funds are not used for the intended purposes
		funds are not properly accounted for
		funds do not achieve value for money
3. Non-financial risks	**3.1 Macroeconomic risks**	poverty reduction objectives (and PFM standards) are compromised by macroeconomic framework
	3.2 Governance risks	poverty reduction objectives (and PFM standards) are compromised by governance context
	3.3 Partnership (or dialogue) risks	partnership is threatened by government action
4. Procurement risks[9]		proper and effective use of aid is compromised by procurement standards
5. Reputational risks		donor reputation is threatened by: i. governance issues; ii. perceived mis-/ poor use of funds

4.4 This typology was a methodological research instrument, a typology against which individual donors' categorisation of risks were mapped in order to review the similarities and differences in donors' approaches. This typology is not a proposal of a standard way of organising all the risks identified by all donors. Each donor has their own approach to identifying, defining and prioritising risk. A particular difference is that risk perceptions may be structured by whether the donor is a bilateral donor that gives aid as grants or a

[9] Procurement risks are not part of this stocktake, but nevertheless are an important part of the risk environment.

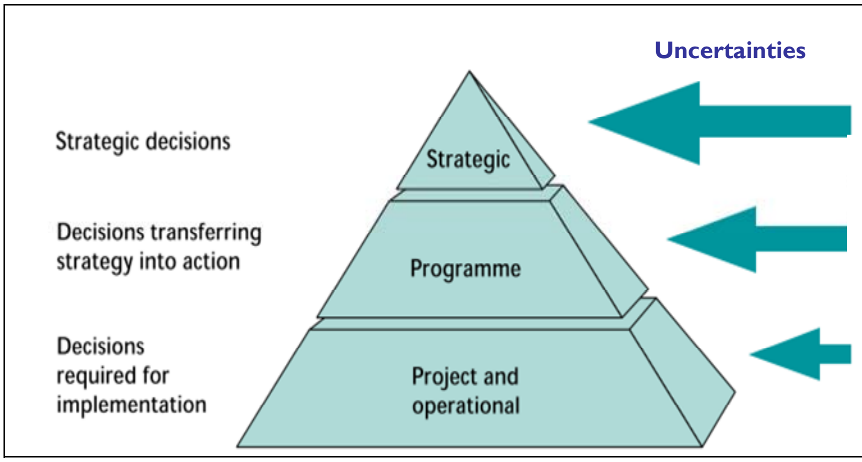
multilateral donor that lends funds. The synthesis of the stocktake findings on individual donor typologies of risks is presented in Chapter 5.

Hierarchy of risk management

4.5 To understand how risk management works in practice it is important to consider the hierarchy of risk management (depicted in Figure 4.1). This stocktake has covered donors' risk management approaches at each decision level: strategic, programme and operational.

4.6 Unpacking risk management approaches through this hierarchy makes it possible to explore how donors' decisions at the different levels may affect the use of country systems in practice. For example there could be a lack of coherence between strategic and operational levels (if the operational level has a shorter-term horizon, or if the operational level proposes specific mitigations which frustrate benefits, and/or fail to take account of the cumulative costs of mitigation measures).

Figure 4.1: Hierarchy of risk management



Strategic	- overall policy on use of country systems
Programme	- eligibility of country - aid modality portfolio within country
Operational	- design and implementation of particular aid instruments

Source: adapted from HM Treasury, 2004.

Risk management model

4.7 Managing risk is not a linear process:

- It involves balancing a number of interwoven elements.
- Risks cannot be addressed in isolation; the management of one risk may have an impact on another, or management actions can control more than one risk. (HM Treasury, 2004)
- It is not only an entry-level decision; it involves continuous management of an aid portfolio.

4.8 A standard risk management model, adapted for this stocktake of approaches to using country systems, is shown in Figure 4.2.

4.9 The outer ring of the model shows the context within which donors are operating. Donors are accountable to their domestic constituencies, which is their public (through their parliament) for bilateral donors and their shareholders (through the board of directors or equivalent) for multilateral donors. Donors are held to account through independent auditors. As well as formal lines of accountability, donors are sensitive to relevant public opinion.

4.10 Donor accountability includes:

- their developmental mandates to reduce poverty.[10]
- their obligations to ensure that their funds are used for the purposes intended.
- requirements to achieve value for money.

4.11 Giving aid is a risky business. Donors must meet their responsibilities and manage their resources in an environment that is high risk. Donors' accountabilities will drive their decisions on what risks to take. In order to meet their obligations, donors monitor the use and impact of their funds. For project funds this means monitoring the individual project budget and performance. If projects are implemented through country systems, donors are likely to rely on country systems also for project monitoring and reporting. Programmatic aid that is delivered through budget support entails the monitoring of country systems and performance as a whole.

4.12 Donors cannot manage risks in isolation. The shaded ring of Figure 4.2 draws attention to the different stakeholders involved. Each donor's attempts to manage risk will have effects on the risk environment for other donors, and for the partner government. Donors' accountability to their constituents has to be upheld in the context where partner government ownership of its poverty reduction strategy and leadership of aid management is vital for the effective delivery of aid. Successful risk management is therefore always a shared endeavour between donors and governments.

4.13 Regarding the environment in which use of country systems takes place,

- this environment is not static, and there are possibilities to influence it (e.g. one of the ways for addressing risk may be to increase government capacity, or to educate public opinion about the nature of risks and which risks are worth taking).
- donors are part of each other's environment (and can affect each other positively or negatively).

4.14 The inner ring of Figure 4.2 shows a continuing cycle of identifying, assessing, addressing and monitoring risks. These elements are reviewed in the following chapters:

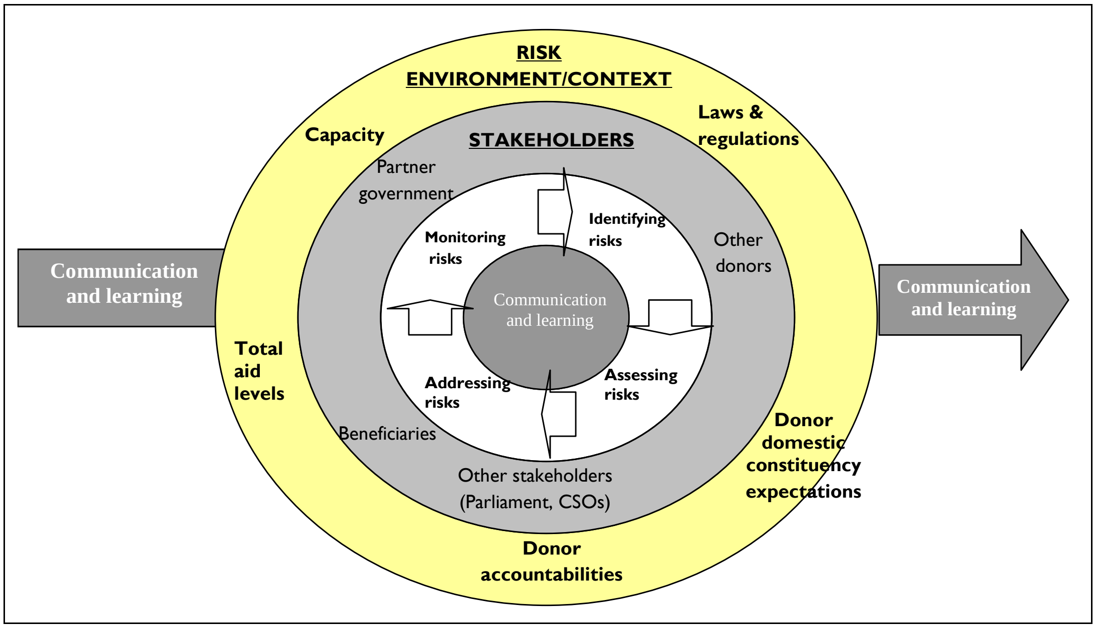
- identifying risks in Chapter 5;
- assessing risks in Chapter 6;
- addressing and monitoring risks in Chapter 7.

4.15 The process of communication and learning (depicted as the horizontal arrow on Figure 4.2) is one that donors can work on together (including with partner governments), and to which this report contributes.

4.16 Last but not least, in the partnership between donors and governments, there are risks, as well as potential benefits, to partner governments too that need to be factored into donors' risk management approaches.

[10] In practice, agencies also have other parallel concerns and (especially for specialist agencies) their development objectives may be more narrowly specified.

Figure 4.2: A risk management model



Source: Adapted from HM Treasury, 2004.

Relevant terminology

4.17 The following terms are commonly used when talking about risk management.

Table 4.2: Glossary

Risk	Uncertainty of outcome, whether positive opportunity or negative threat of actions and events is the combination of likelihood and impact, including perceived importance.
Exposure	The consequences, as a combination of impact and likelihood, which may be experienced by the organisation if a specific risk is realised
Inherent risk	The exposure arising from a specific risk before any action has been taken to manage it.
Residual risk	The exposure arising from a specific risk after [effective] action has been taken to manage it.
Risk acceptance	The informed decision to accept the consequences (impact) and the likelihood of a particular risk.
Risk appetite	The amount of risk that an organisation is prepared to accept, tolerate, or be exposed to at any point in time.
Risk avoidance	An informed decision not to become involved in a risk situation.
Risk management	All the processes involved in identifying, assessing and judging risks, assigning ownership, taking actions to mitigate or anticipate them, and monitoring and reviewing progress.
Risk mitigation	The processes built into the controls environment, such as policies, frameworks, accountabilities etc to lower the residual risk.

Source: Adapted from HM Treasury, 2004 and PriceWaterhouse Coopers Effectiveness Review, 2005 [cited by University of Alberta].

Key principles for assessing risk

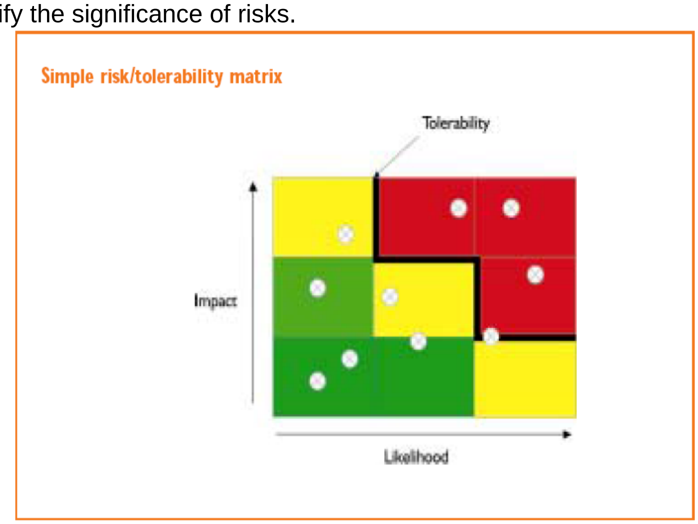
4.18 There are three important principles for assessing risk:

- ensure that there is a clearly structured process in which both likelihood and impact are considered for each risk;
- record the assessment of risk in a way which facilitates monitoring and the identification of risk priorities;
- be clear about the difference between inherent and residual risk (see Table 4.2 above).

4.19 Figure 4.3 illustrates a systematic process for evaluating both the likelihood and impact for each risk.

Figure 4.3: Evaluating likelihood and impact of risks

Evaluating the likelihood of the risk being realised, and the impact if the risk is realised. A categorisation of high /medium / low in respect of each may be sufficient, and should be the minimum level of categorisation – this results in a “3x3” risk matrix. A more detailed analytical scale may be appropriate, especially if clear quantitative evaluation can be applied to the particular risk - “5x5” matrices are often used, with impact on a scale of “insignificant / minor / moderate/ major/ catastrophic” and likelihood on a scale of “rare / unlikely / possible / likely / almost certain”. There is no absolute standard for the scale of risk matrices – the organisation should reach a judgement about the level of analysis that it finds most practicable for its circumstances. Colour (“Traffic Lights”) can be used to further clarify the significance of risks.



Source: HM Treasury, 2004.

5. Defining Risks

Introduction

5.1 This chapter covers the identification of the different types of risks that donors routinely face when seeking to use partner country systems. Chapter 6 examines donors' arrangements for assessing the risks.

5.2 There is inevitably considerable overlap in defining and categorising risks and some risks cannot easily be compartmentalised. Different donors have different views on how to categorise risks. This stocktake has attempted to identify the main risks considered by each donor, and how each donor categorises and defines these risks, highlighting the main commonalities and differences between donors. The chapter sets out the risks identified and mapped against the study risk typology, in the following order:

- developmental risks
- financial risks
- non-financial risks, and
- risks of corruption.

Definition of developmental risks

5.3 This is the over-arching risk identified by donors that the stated developmental objectives will not be achieved. Canada, Sweden, the Asian Development Bank and the World Bank (Table 5.1) define the developmental risk as the risk of not achieving the stated development objectives. Other donors' identification of developmental risk can be interpreted from the focus of their strategic analysis and risk assessments: 'poverty reduction and sustainable development' (UK); 'poverty and inequality' (France); 'poverty reduction' (Germany) and 'progress towards achieving the objectives in terms of impacts and results' (EC). Developmental risks can be caused by both financial and non-financial risks.

Table 5.1: Donors' definitions of developmental risks

Bilaterals	
Canada	• Risk that the assistance will not achieve its stated development objectives.' • Sub-categories of developmental risks: - *'Implementation risk* – risks and uncertainties that the program being supported may not be implemented or may not be able to be implemented as planned, due for example to limited capacities, to insufficient funding, or to other constraints. - *Under-achievement risk* – risks that the reforms and programs will not produce the expected results or those targets may be overly optimistic. - *Sustainability risk* – the risk that achievement attained may not be sustainable, for example due to weak local ownership or commitment, inability to sustain the cost of the program or insufficient capacity. - *Environment risk* – the risk that environmental issues are not sufficiently addressed and the risk of severe impact on the environment caused by inappropriate environmental risk mitigation measures. - *Gender risk* – the risk that gender issues may not be appropriately addressed with the resulting imbalance in benefits to both men and women.
Sweden	• Developmental risk can be defined as the risk that developmental objectives will not be achieved due to weaknesses in the system.

Multilaterals	
AsDB	• The risks that might occur during implementation of the [Country Strategy and Program] and which might reduce the likelihood of results achievement.
World Bank	• Possibility that objectives will not be realized and that impact will be less than if regular Bank policies had been used. • Risks that the operation fails to achieve the expected development impacts or that it will have unanticipated adverse impacts on vulnerable groups or on the environment.

Source: individual donor policies and guidelines – see Annex H for reference list.

Definition of financial risks

5.4 Donor countries generally refer to financial risks in one of two ways – *fiduciary risk* and *public financial management risk*. Some donors see fiduciary risk as being limited to the misuse of funds (or other assets); other donors use fiduciary risk to cover all financial risks, including the risk of corruption. In this stocktake, we have not attempted to distinguish between these definitions, or to identify preferred usage for the various terms. Throughout the report, we refer to financial risk as including fiduciary and public financial management risk factors.

5.5 There are, however, inconsistencies between donors in their respective understandings of what financial risk covers and how the risk is expressed for the purpose of carrying out risk assessments. Annex E1 sets out the various definitions currently used by each donor and these positions are summarised in Table 5.2 below.

Table 5.2: Donors' definitions of financial risks

Bilaterals	
Canada	The term *fiduciary risk* is used in relation to the use of and reliance on the public financial management and accountability systems. Specific definitions are given for '*not used for purposes intended', not properly accounted for';* and *'goods and services acquired are not commensurate to funds transferred*'. CIDA's definition of financial risks includes not only fiduciary risk, but also risks related to funding and to instruments.
France	*Fiduciary risk* refers to the risk that: • budgetary resources are not employed according to the forecasts and in a transparent way; • budgetary expenditure does not follow effective procedures of execution and control; • the operations of expenditure are not reflected in regular and adequate accounting, recording and transparent financial reports; • budget expenditure is not subject to appropriate external controls. The French concept of fiduciary risk is less extensive than other donors in that it does not include the risk of inefficient and ineffective use of capital (value for money).
Germany	*Fiduciary risk* is addressed by reference to funds that are put at the partner country's disposal through programme based joint funding. Specific definitions are given for '*not used for purposes intended; 'not properly accounted for'; and 'do not achieve value for money'.*
Netherlands	The Netherlands works with a risk-based approach, but does not really use the concept of fiduciary risk. Applying the risk typology presented in Table 4.1., for the Netherlands financial/fiduciary risk comprises notably the elements: 1. not properly accounted for: funds cannot be traced, cannot be accounted for; 2. not used for purposes intended: the funds can be traced, but are not used for agreed – especially poverty alleviation – goals.

	The element achieving value for money partly focuses on procurement and partly on the quality of governance and of (sector) policies, hence going beyond PFM. In a context of efficiency of the public sector and achieving the MDGs and value for money, the Netherlands identify two specific risks: - 'Sector' risk (in the area of value for money), pertaining to sector-specific PFM and to sector-specific policies; and, - 'Decentralisation' risk, the (governance) risk that local councils use lump sums differently from the way envisaged in the dialogue at central level.
Sweden	*Fiduciary risk* is the risk that funds are not used for intended purposes, are not providing value for money and are not properly accounted for.
UK	*Fiduciary risk* is the risk that funds are not used for the intended purposes; do not achieve value for money; and/or are not properly accounted for. The realisation of fiduciary risk can be due to a variety of factors, including lack of capacity, competency or knowledge; bureaucratic inefficiency; and/or active corruption.
Multilaterals	
AsDB	*Fiduciary risk* in the development aid context is the risk that aid funds are not used for the intended purposes, do not achieve value for money, and/or are not properly accounted for. Fiduciary risk is of particular concern when donors provide direct budget support, as partner governments' public financial management systems are often relatively weak. Corruption is one type of fiduciary risk.
EC	*Fiduciary risk* is the risk of fraud or corruption. There are other definitions, used in the context of public financial management systems that differ subtly in their references to the system being transparent, reliable, accountable, equitable, efficient, and effective.
World Bank	*Fiduciary risk* is the risk that loan proceeds will not be used for the purposes intended. *Financial Management(FM) risk* (component of fiduciary) concerns risks associated with FM arrangements (budgeting, accounting, internal control, funds flow, financial reporting, and auditing arrangements of the entity responsible for implementing Bank-supported operations); and perceived weakening of fiduciary policies with a deviation from Bank policies.

Source: individual donor policies and guidelines – see Annex H for reference list.

5.6 While donors' definitions are not always precise or clearly articulated, donors are all pointing in the same direction. It would, however, be helpful for donors, partner countries, and third parties, such as country NGOs, if donors adopted common harmonised definitions. This would reduce confusion and facilitate greater use of shared financial risk assessments.

Key Commonalities	Each donor is concerned with *fiduciary* and *public financial management* risks, however expressed (see below for their particular perspectives on corruption).
Key Differences	Canada specifically links the risk of funds not being used for purposes intended to the programme's risk mitigation strategy. France adopts a narrower definition, which is reflected in its approach to carrying out financial risk assessments.
Opportunity	Opportunity for donors to share and learn from their different understandings of the different types of financial risk

Definition of non-financial risks

5.7 Donors' identification of potential non-financial risks of using country systems tends to be less well-developed than their identification of financial risks. The donors covered in the stocktake do not consistently spell out their understanding of non-financial risks. Some donors define some non-financial risks but no donor defines all the non-financial risks that it recognises. In addition, donors' definitions of the same risks often differ.

Macroeconomic risks

5.8 Germany, UK, the EC and the World Bank (Table 5.3) define macroeconomic risk as the risk that macroeconomic factors or context may have a negative impact on poverty reduction results. Different donors highlight different economic risk factors. All donors assess the strengths and weaknesses of partner countries' macroeconomic frameworks when deciding the optimum level of alignment with a partner country's systems.

Table 5.3: Donors' definitions of macroeconomic risks

Bilaterals	
Canada	• Risks related to the economic environment (i.e. regional currency crisis, global/regional recession, sharp spike in petroleum prices, etc.)
Germany	• Risk that macroeconomic factors / context may have a negative impact on poverty reduction results.
UK	• Macroeconomic difficulties arising from exogenous shocks or inappropriate policy may lead to shifts in patterns of expenditure and financing (e.g. higher borrowing) which weaken poverty reduction progress.
Multilaterals	
World Bank	• Risks to consider when assessing the sustainability of a country's medium-term macroeconomic framework: fiscal and debt sustainability risks. .. balance of payment vulnerabilities. … monetary and exchange rate risks. … financial sector risks. … corporate sector risks. …

Source: individual donor policies and guidelines – see Annex H for reference list.

Governance risks

5.9 Canada, the Netherlands, the UK and the EC define governance risks in various ways (Table 5.4). They share a focus on the government's 'capacity to govern and lead' and accountability. Some bilateral donors refer explicitly to 'political risks' in this context, but see also Table 5.5. Other donors do not have a definition of governance risks but all donors undertake governance assessments to inform decisions to use country systems.

Table 5.4: Donors' definitions of governance risks

Bilaterals	
Canada	• Risks related to the political stability, human rights, rule of law and capacity of government to manage public resources for the delivery of services.
Netherlands	• Risk [to] policy consistency and accountability. • (See Table 5.2 for the Netherlands' identification of governance PFM risks – sector and decentralisation)
UK	• Risk that the three requirements for good governance (state capability, accountability, and responsiveness) are missing.
Multilaterals	
EC	• Lack of democratic government could be considered internal political risk. • The weaker the administration of the partner country, the higher the risks in terms of effectiveness and efficiency. • Legislative risks (extent current legislation impinges on development programmes/projects). • Social risks (ethnic and religions conflicts; labour unrest; child labour issues; increased income inequality).

Source: individual donor policies and guidelines – see Annex H for reference list.

Partnership risks

5.10 This category (Table 5.5) covers a variety of risks called different things by different donors:

- *Accountability risks* – the risk that vertical accountability of government to donor will develop to the detriment of domestic accountability (Canada, UK).
- *Political risks* – the risks relating to the underlying political relationship between the donor and the partner country (Canada, Germany, UK).
- *Predictability risks* – the risk that budget support will be subject to unpredictability. There is a two-way causal relationship with political risks: on the one hand, disruption to aid flows (suspension, termination) will cause political tensions (Germany and the EC); on the other hand, the political relationship is the biggest risk to the predictability of budget support (UK).

Table 5.5: Donors' definitions of partnership risks

Bilaterals	
Accountability risks	
Canada	While ensuring appropriate oversight and reporting to meet its own accountability requirements, donors such as CIDA need to take a long-term approach and ensure that accountability demands do not overshadow those of developing countries' own emerging national institutions.
UK	Risk that budget support might distort domestic accountability if meetings about budget support are used to make key decisions about the budget and policy priorities.
Political and predictability risks	
Canada	Political risks: political situation (i.e. elections, regional conflict, changes in crime/security situation)
Germany	Political risks may appear if partner country's government performance starts unexpectedly to decline. Where this arises in an aid-dependent country, the suspension of budget support may significantly prevent the state from carrying out its functions, threatening not only macroeconomic stability but political stability too.
UK	The Joint Evaluation [of General Budget Support] found that the underlying political relationship between donors and governments is the main risk to budget support being delivered in a predictable way. The UK experience reflects this finding and is often referred to as political risk. Political risk refers to the uncertainty and instability resulting from political conditions, particularly changes to government, regime or policy. It poses challenges for DFID since it covers a variety of threats, with a variety of impacts. Political risks might include: a coup that brings in a military regime and human rights abuses; a change of government that undermines partnership agreements already established; or changes to core policies that are anti-developmental.
Multilaterals	
Political and predictability risks	
EC	• Overarching risk from predictability – at political level, each disruption, slowing down or question mark on country's (economic) governance likely to raise political tensions.

Source: individual donor policies and guidelines – see Annex H for reference list.

Reputational risks

5.11 Canada, the Netherlands, Sweden and the World Bank define reputational risk (Table 5.6). Sweden and the Netherlands point to the general and political nature of budget support as creating risks for the donor.

Table 5.6: Donors' definitions of reputational risks

Bilaterals	
Canada	• This risk arises in all types of financial support: risk of perceptions, real or otherwise, of poor management, including corruption, underachievement, missed opportunities and the choice of a particular modality in particular. Often perceived as a donor domestic political issue, which may affect the donor's ability to support a program-based approach. It is also relevant to recipient country governments/organizations in their accountability to their own citizens for the management of public finances. Reputation risk thus imposes costs or limitations both on donors and recipient countries.
Netherlands	• Risk that the reputation of the Netherlands is harmed by investing in a corrupt organisation or being involved in corruptive practices. • Includes the risk that when giving general budget support, the donor country is held politically accountable for all actions of the partner country – including in areas such as human rights, conflicts, etc.
Sweden	• The general and political nature of budget support also creates risks for the donor. In practice, budget support is tantamount to support for country's policies as a whole, and donors may be called to account by their own taxpayers for the general policies pursued by that country's government and for its overall use of public funds.
Multilaterals	
World Bank	• Risks that the operation damages the Bank's long-term ability to mobilize support and resources for its mission. Included in this is risk that the country will lack sufficient capacity to service its Bank debt and that the program will damage the Bank's reputation among member governments and other stakeholders.

Source: individual donor policies and guidelines – see Annex H for reference list.

Key Commonalities	Donors do not tend to have well-developed non-financial risk definitions.
Key Differences	Canada and the World Bank do have well-developed non-financial risk definitions.
Opportunity	There is considerable scope for clarifying and standardising the terminology relating to non-financial risks.

Definition of risks of corruption

5.12 The Paris Declaration describes as a remaining challenge:

> Corruption and lack of transparency, which erode public support, impede effective resource mobilisation and allocation and divert resources away from activities that are vital for poverty reduction and sustainable economic development. Where corruption exists, it inhibits donors from relying on partner country systems. (High Level Forum, 2005: ¶4(v).)

5.13 Each of the donors covered by the stocktake is concerned with the risk of corruption. Corruption is defined by Transparency International as 'the use of entrusted power for private gain'. Some donors include corruption under the category of 'governance' risks (covered above in the section on non-financial risks) while other donors see it as a key feature of their fiduciary risk work. The World Bank addresses governance and corruption simultaneously in its Governance and Anti-corruption approach, which also includes partner countries' public financial management systems. Donors' definitions of the risks of corruption are set out in Table 5.7.

Table 5.7: Donors' definitions of risks of corruption

Bilaterals	
Canada	A risk that developing country governments or organizations could misuse power and/or resources for private gain.
France	Not specifically defined – the risk of corruption is 'globally determined by the four dimensions characterising fiduciary risk'.
Germany	Not specifically defined (from the material available).
Netherlands	The Ministry uses a broad definition of 'corruption', which includes the various offences mentioned in the UN-Convention against Corruption. Examples of corruption are given for each of three fiduciary risks: funds (or other assets) are not used for intended purposes (e.g. used for illicit private gain); funds are not properly accounted for (e.g. deliberate misallocation of funds or deliberate misreporting for private gain); funds do not achieve value for money (e.g. inflation of costs and pocketing or sharing difference between invoice price and actual price). Also identified: 'risk that corruption is counterproductive in reaching the desired development goal'.
Sweden	The risks of corruption and dealing with any cases of misuse of Swedish financing of development co-operation that may arise. Corruption in this context means institutions, organisations, companies or individuals obtaining improper gains by their position in an operation and thereby causing damage or loss. It includes kickbacks and bribery, extortion, favouritism and nepotism, and also embezzlement, racketeering, conflicts of interest and illegal financing of political parties. Extensive corruption entails a significant risk of unfavourable effects on development in, for example, combating poverty, economic development, the rule of law and a democratic social structure.
UK	DFID uses Transparency International's definition: 'the abuse of entrusted power for private gain'.
Multilaterals	
AsDB	Corruption is one type of fiduciary risk, which in the development aid context is the risk that aid funds are not used for the intended purposes, do not achieve value for money, and/or are not properly accounted for.
EC	Not specifically defined.
World Bank	Defined as 'the abuse of public office for private gain' and seen as one outcome of poor governance.

Source: individual donor policies and guidelines – see Annex H for reference list.

Key commonalities	Donors have different definitions of corruption but are all concerned with assessing the risks of corruption.
Key differences	Some donors assess the risks of corruption as part of their work on financial risk; others treat it as part of their work on governance.
Opportunity	For donors to reach a common understanding of the risks of corruption.

6. Assessing Risks

Introduction

6.1 Each donor undertakes a number of different assessments to inform their decision whether to use country systems, and to monitor risks. Annex D provides a detailed picture of each donor's assessment process. This chapter reviews:

- donors' risk assessment processes;
- donors' practices in relation to financial and non-financial risks, focusing on what is assessed, the evidence base and scoring methodology;
- recent and planned changes in risk assessments;
- donors' approaches to evaluating risks (likelihood and impact).

Overview of assessment process

6.2 Donors have different procedures for assessing the risks involved in using country systems. The Netherlands has one integrated assessment tool but the majority of donors have a number of assessment tools covering different areas (commonly split into a governance assessment, a macroeconomic assessment, and a fiduciary risk assessment). Annex D provides a summary by donor of the risk assessments that each donor carries out.

6.3 The assessments are not always termed 'risk' assessments. Generally, assessments of financial risks are, while assessments of non-financial risks are not. (For example, DFID assessments to identify risks of using country systems include a 'Fiduciary Risk Assessment' and a 'Country Governance Analysis'.) Donor country strategy analysis may also assess the strengths and weaknesses of country systems and identify the risks. (For example, analysis behind the World Bank country assistance plan informs the level and composition of Bank Group financial, advisory, and/or technical support to the country, including the appropriateness of providing development policy lending.)

6.4 Assessments to inform the use of country systems are carried out at different levels of programme and operational planning:

- at the programme level – to inform country and sector strategy;
- at the operational level – as part of the individual aid instrument preparation process.

6.5 Risk assessments are not only entry-level decision tools. Donors continuously monitor risks and update their risk assessments. This monitoring is an important element of donors' risk management strategies (discussed further in Chapter 7 on addressing risks, ¶7.36–¶7.41). Donors commonly have a formal requirement to update their assessments annually.

6.6 The full country-level strategy analysis is usually undertaken by donors around every three to four years. These assessments are undertaken by donor country teams and approved by the highest accountable post-holder (for bilaterals: the responsible political office-holder; for multilaterals: the Board of Directors for the Asian Development Bank, the Financing Committee for the EC, the Board of Executive Directors for the World Bank). The donors have rigorous quality assurance procedures for each risk assessment.

Financial risk assessments

6.7 This section examines each donor's approach in carrying out financial risk assessments and includes:

- what the risk assessment arrangements cover;
- the evidence base for the risk assessment, including the use of diagnostic tools and indicators;
- the way risks are scored and categorised.

Focus of financial risk assessment

6.8 Most of the donors covered by the stocktake carry out a country-level financial risk assessment as part of their strategic planning to assist in determining their country assistance plans, including, for example, the mix of aid modalities. It is the outcome of this risk assessment that is generally used to determine the extent to which individual donors can, and will, rely on country systems, particularly in providing budget support.

6.9 A detailed description of the focus and content of each donor's financial risk assessment arrangements is at Annex E2. The key features of each donor's approach at country level are set out in Table 6.1.

Table 6.1: Donors' approaches to assessing financial risks at country level

Bilaterals	
Canada	Fiduciary risk is considered in relation to the use and reliance of the public financial management and accountability systems, including the procurement policies and practices, of a recipient country. CIDA's internal procedures for carrying out a fiduciary risk assessment focus on an assessment of whether it is reasonable to expect that the resources transferred to a recipient country will be used for the intended purposes, properly accounted for, and that expenditures are commensurate to funds transferred.
France	A financial risk assessment, focused on the mechanics of the PFM system, plus a further evaluation drawing on additional indicators and diagnostic evidence, including the perceived level of corruption. The evaluation includes a qualitative assessment of the country government's commitment to reform. (The process for carrying out fiduciary risk assessment is in the process of being revised. A draft Policy Note was issued in December 2007 and has yet to be finalised. The material included is drawn from this draft policy and hence is provisional.)
Germany	A financial risk assessment, based on a detailed analysis of partner country PFM systems, is mandatory and is central to the pre-appraisal carried out upon a funding request from a partner country. This includes progress on reforms, but no separate assessment on corruption (included in checklist and indicators).
Netherlands	An analysis of partner country PFM systems, focusing on budget policy and budget management, feeds into the Track Record. This is supplemented with a risk analysis concerning policy consistency and accountability. The Track Record assesses a government's actual performance in terms of policy implementation and as such is backward looking. New policy plans can be identified in the appraisal but should not be given much weight, unless they have already been approved by parliament and implementation has begun Other assessment instruments also cover financial risk assessment: • The Strategic Governance and Corruption Analysis (SGACA) plays a role as an input in the Track Record (C2 effectiveness and corruption risk). • The Sector Track Records feed into the Track Record analysis and shape the programme. • At the activity level risk assessments are undertaken for individual activities.

Sweden	Assessment of fiduciary and developmental risks in utilising country systems is carried out on the basis of an analysis of the budget and of PFM systems. In the cooperation strategy process, two basic areas are assessed: • *Budget analysis*: • *Technical status and capacity of the PFM system* Sida assesses the actual status of the PFM system in relation to relative trends in the development of systems, PFM capacity, and the way in which systems are used in practice. An important issue is whether any reforms under way are likely to strengthen openness, access and transparency. The risk of corruption is given a prominent place in the PFM assessment.
UK	A financial risk assessment is required for each country where DFID is considering providing financial aid. The report includes a judgement on overall risk and a statement on key risks, including corruption, and a statement on whether there is a credible programme of PFM improvement.
Multilaterals	
AsDB	At a country or national systems level, risk assessment of PFM national systems should cover: i) Legislative & Policy Framework, ii) Institutional Arrangements and Capacity, ii) Budget Formulation, iii) Budget Execution, iv) Budget Accounting and Reporting, v) External Audit and Oversight. At a country or national systems level, risk assessments of corrupt practices in the use of national financial systems or, more generally, in financial activities should cover: i) Legislative and policy framework, ii) Integrity institutions and systems, iii) Rule of Law, iv) Administrative Quality, v) Voice & Accountability, vi) Public Perceptions Sector and project and programme risk assessments usually include an assessment of risks associated to PFM operations and corrupt practices, both of 1) national systems and of 2) systems created specifically to manage AsDB projects
EC	Country programming analysis includes analysis of the quality of public finances and the structure of budget revenue and expenditure. Progamming tool 'Governance Profile' includes assessment of PFM quality under the area of 'government effectiveness'. The assessment areas for budget support and sector support include analysis of the quality of the PFM system (and the country's national budget and medium term expenditure framework) and the PFM reform process.
World Bank	An assessment of governance, including corruption and public financial accountability issues, feeds into the Country Assistance Strategy. The Bank is in the process of implementing new guidelines on assessing governance in this area.

Source: individual donor policies and guidelines – see Annex H for reference list.

6.10 CIDA is able to rely on a financial risk assessment previously carried out by another donor – it will ensure that the assessment is sufficiently current, thorough and objective, and will make its own evaluation of the level of financial risk in the context of the proposed PBA initiative.

Key Commonalities	Most donors are concerned to determine the strengths and weaknesses of partner country PFM systems, along with the risk of corruption.

Key Differences	Many donors (France, Germany, Sweden, UK and EC) include an assessment of whether there is a credible programme of PFM reform. The World Bank's focus is on assessing the overall level of governance (including PFM) and anti-corruption to inform a greater emphasis on strengthening partner country performance in World Bank operations. France focuses on the specific mechanics of the PFM system. Issues such as performance against objectives and value for money are considered separately. Within the study group, Canada is alone in being able to rely on financial risk assessments carried out by other donors.
Opportunities	Given the similarity of approach, and the same overall objective, there would be advantages (in terms of harmonisation, partner country involvement and ownership, and reduced transaction costs) in donors adopting a unified approach to carrying out financial risk assessments at partner country level. To facilitate moving towards a harmonised approach, the JV-PFM could consider comparing the approaches of several donors in a sample of countries to establish the compatibility, in practice, of completed financial risk assessments, and identify constraints to the notion of 'one fiduciary risk assessment for all'.

The methodology (evidence base) for carrying out financial risk assessments

6.11 This section covers the sources of evidence for donors' fiduciary risk assessments and their use of specific performance indicators to inform the assessment.

6.12 The PEFA framework was designed to provide an assessment of the standard of a country's PFM systems and practices at a given point in time and, through repeat assessments, to enable progress to be monitored over time. Its main rationale was to unify donors' different diagnostic practices for assessing PFM systems into one tool, which each donor endorses:

> The PEFA PFM Performance Measurement Framework has been developed as a contribution to the collective efforts of many stakeholders to assess and develop essential PFM systems, by providing a common pool of information for measurement and monitoring of PFM performance progress, and a common platform for dialogue. (PEFA Secretariat, 2005)

6.13 The PEFA framework provides a useful starting point for carrying out a financial risk assessment and all the donors use it for this purpose. However, it is *just a starting point.* It was not designed as a financial risk assessment tool and this is explicitly recognised by several of the donors: The Netherlands' position makes this clear:

> PEFA only provides technical information on the functioning of PFM and does not give a value judgment on the risks that funds cannot be accounted for or are not used as intended' (DEK, 2007b).

As such, a financial risk assessment must look beyond the PEFA assessment and draw on additional information. In particular, the risk assessment needs to identify, and consider the impact of, the underlying causes of poor performance.

6.14 Understanding the historical, governance and institutional context of partner countries' PFM systems and processes is also important for an effective assessment of risk. And use of information outside the PEFA framework is essential for assessing the risk of corruption (¶6.35 refers).

6.15 Each of the donors recommends, in its guidance, that the relevant country PEFA assessment should be supplemented with additional evidence and indicators as necessary. Common among these are:

- Country Financial and Accountability Assessments and Public Expenditure Reviews (World Bank);
- Fiscal Reports on the Observance of Standards and Codes of Fiscal Transparency (IMF);
- Public Expenditure Tracking Assessments and Assessment and Action Plans (AAPs) for Heavily Indebted Poor Countries (World Bank/IMF);
- Country financial information such as financial statements, audit reports, service delivery surveys, and public expenditure tracking surveys.

6.16 A further limitation of the PEFA framework is that it focuses on the broad national level. While this is useful in gaining an understanding of overall country level PFM issues, donors need an understanding of risks at sub-national and sector levels, and below this, at the level of individual aid instruments. Donors therefore need to obtain additional information on the state of PFM systems at these lower tiers and the PFM issues that are relevant may be different from the country level – the nature of operations in particular sectors may carry inherent fiduciary risks not addressed in the PEFA framework.

6.17 The PEFA framework is an important step in donor harmonisation, and a significant contribution to the process of strengthening partner country PFM systems. As discussed later (in Chapter 8) it may provide a pattern for similar collaboration among donors and governments on additional financial and non-financial assessments that are relevant to the use of country systems. At the same time there is a danger that demands on PEFA itself as an element in risk analysis may undermine some of its core functions:[11]

- demands for over-frequent PEFA reports would be unhelpful (PEFA is not calibrated to register very short-term changes in performance, and there are considerable transaction costs, including for the partner country government, in undertaking a proper PEFA assessment);
- linking PEFA scores directly to benchmarks and conditions could create pressures to distort the scores recorded.

6.18 Most donors recommend specific indicators that should be used to inform the risk assessment. Donors have adopted different approaches, drawing on some or all of the PEFA indicators, along with other indicators associated with different diagnostic tools. Most of the donors use the PEFA indicators as their starting point, though CIDA and the World Bank are less prescriptive. Given the common objective and approach to carrying out fiduciary risk assessments, donors have specified a surprising array of different indicator sets (illustrated in the table below). A more detailed analysis of which of the PEFA indicators are used by which donor is at Annex E3.

[11] The appropriate use and development of PEFA is being considered under a separate stream of work sponsored by the JV-PFM

Table 6.2: Donors' use of specific performance indicators

Bilaterals	
Canada	No indicators are specified.
France	The set of indicators to be used is under development.
Germany	A set of 12 indicators (covering 17 of the PEFA indicator set) under five PFM dimensions.
Netherlands	The 28 PEFA indicators are used to rate the six PEFA dimensions of PFM.
Sweden	The full set of PEFA indicators is used to inform the assessment of the two areas: • Budget analysis: • Technical status and capacity of the PFM system. Alternatively DFID's matrix and scoring system can be used.
UK	A summary of the PEFA indicator scores are included in the body of the Fiduciary Risk Assessment. In describing PFM performance, assessors have the option of using either the PEFA indicators or DFID's 15 benchmarks (which are not explained further).
Multilaterals	
AsDB	No indicators are specified. The PEFA assessment is one of various sources that the recently drafted (2008) guidelines for the implementation of the AsDB's Second Governance and Anticorruption Action Plan (GACAP II) recommends using when assessing national PFM, procurement and anti-corruption systems.
EC	Guidance sets out a list of detailed questions which refers to 26 of the 28 PEFA indicators.
World Bank	The WB implementation plan on governance and anti-corruption lists the PEFA indicators as the primary indicators for measuring the quality of PFM processes.

Source: individual donor policies and guidelines – see Annex H for reference list.

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6.19 Germany has identified a narrower set of PEFA indicators, focusing on the mechanics of the PFM system, to inform their assessments of fiduciary risk. For Germany, the indicator-based assessment is supplemented by a qualitative checklist-based analysis. Other donors are interested in the systems of PFM in their totality. For example, weaknesses in revenue collection, resulting in lower than expected tax revenues, could lead to risks materialising in other areas, possibly resulting in the direction of aid away from initiatives to reduce poverty.

Key Commonalities	All donors recommend using the PEFA framework as a starting point for carrying out a financial risk assessment. All donors recognise the limitations of the PEFA framework in assessing risks and recommend that additional evidence be drawn from other diagnostic tools and sources.
Key Differences	Donors have varying approaches in specifying the performance indicators to be used in informing the risk assessment.
Opportunity	Donors could examine the scope for using a common set of indicators, based on PEFA, to inform their initial assessment of risk in partner countries' PFM systems. Donors should be careful not to (mis)use PEFA in ways that could undermine its core functions.

Donors' methodology for scoring financial risk assessments

6.20 Each donor has a mechanism for categorising the level of risk identified in its assessment process. Some of these mechanisms are relatively rigid, while others allow assessors to exercise an element of judgement. Each donor's approach is set out in Annex E4 and summarised in Table 6.3 below.

Table 6.3: Summary of donors' scoring mechanisms for financial risk assessments

Bilaterals	
Canada	No information available on scoring for fiduciary risk assessment in particular.
France	The draft policy contains guidance for each indicator to be scored and an average overall score calculated which equates to a classification of risk from low to very high.
Germany	Each indicator is scored and given a trend assessment. There is no overall assessment.
Netherlands	Each indicator is rated and this is used to calculate a rating (highly satisfactory) to (highly unsatisfactory) of a central question based on the six PFM dimensions. The Track Record scoring system is based on value judgement of the Embassy; the PEFA performance report and indicators are used as important references.
Sweden	Either PEFA's performance indicators and scoring system is used or DFID's matrix and scoring system.
UK	PEFA indicators are assessed on a four point scale and DFID have assigned 'rules of thumb' to interpret each score. DFID's benchmarks have traditionally been assessed on a three point scale, with an indicator of trend. The Fiduciary Risk Assessment indicates an overall level of risk on a four point scale from low to high.
Multilaterals	
AsDB	The GACAP II draft guidelines (2008) propose the following scoring system to rate the PFM, procurement and corruption risks: (1) Likely; (2) Relatively Serious; (3) Not mitigated over CPS period; (4) Major Risk (when (1)–(3) are 'true').
EC	From the information available to the stocktake, there does not appear to be a specified scoring methodology or mechanism for country programming financial risk analysis or for the assessment of the quality of public finances undertaken for GBS and sector support. The governance assessment, which includes an assessment of PFM systems under the government effectiveness area, does have a scoring methodology (see ¶6.32 for further details).
World Bank	The World Bank does not have a scoring mechanism at country level.

Source: individual donor policies and guidelines – see Annex H for reference list.

Key Commonalities	Four donors have arrangements for scoring individual indicators and calculating an overall level of risk. Some of these systems are very prescriptive, others provide for more judgement to be exercised on the part of assessors.
Opportunity	There is an opportunity for donors to share their experiences of applying scoring methodologies and to work towards a common approach.

Non-financial risk assessments

6.21 This section considers donors' approaches to non-financial risk assessments:
- what is assessed;
- the evidence base;
- how the assessments are scored.

Focus of non-financial risk assessments

6.22 To ascertain the risks involved in using a country's systems, donors commonly assess the country's:
- developmental strategy and political commitment (cf. Table 5.1 in the previous chapter);
- macroeconomic framework (cf. Table 5.3);
- governance and partnership dimensions (cf. Tables 5.4 and 5.5).

6.23 Each donor has assessment criteria to guide the assessment of these areas. While the focus of donors' assessments is broadly very similar, it is not easy to compare the criteria at a detailed level because each donor has a different way of categorising and grouping the criteria. In addition, donors vary greatly in the level of detail they provide on the assessment criteria. Annex F1–F5 lists the donors' assessment criteria by assessment area.

6.24 The main findings are:

Development assessment: All donors assess whether the national poverty reduction strategy is an adequate strategy framework for poverty reduction and the extent of political commitment to this strategy. To inform their country strategies, donors also assess the country context more generally through social, political, economic and environmental analysis. The World Bank in particular focuses on reviewing a country's social and environmental safeguard systems.[12]

Macroeconomic assessment: All donors assess the partner government's macroeconomic policies and performance. There are some differences in the focus of the assessments (for example, the World Bank focuses on sustainable external and fiscal balances while the Netherlands focuses on effective income redistribution and the ecological sustainability of economic growth). All donors consider the relationship between the partner country and the IMF (see further discussion in ¶6.29).

Governance assessment: All donors use a wide definition of governance that covers state capability, effectiveness, and accountability and includes rule of law and respect for human rights. All include an assessment of the governance of the country's public financial management (covered in the financial assessment section of this chapter). Within governance assessments, donors assess to what extent corruption is being controlled. [13]

Partnership (or dialogue) assessment: The EC and the Netherlands have criteria for assessing 'dialogue' or 'donor coordination' (includes donor-donor and donor-partner country). Germany and the World Bank assess partnership aspects under the developmental and governance assessments and the UK's approach has partnership at the core, as DFID assesses a government's commitment to three partnership

[12] That is, the environmental and social aspects of project implementation, covering issues such as involuntary resettlement, forestry, indigenous peoples, environmental assessment, natural habitats and cultural property.

[13] The DAC Network on Governance has recently (February 2008) undertaken a survey of governance assessments of 30 donors. With the survey focus on a wider set of governance assessments (which may not have the principal aim of assessing risk) for a wider set of donors, the final survey report provides useful information that can supplement this Stocktake. (Boesen, 2008)

principles. An important part of the donor-government partnership focuses on performance monitoring. France, the Netherlands and the EC stress the importance of assessing the government performance measurement system.

Key Commonalities	When deciding whether to use country systems donors commonly assess the country's development strategy and political commitment, the macroeconomic framework, governance and partnership dimensions. There is a lot of overlap in the focus of individual donor assessments.
Key Differences	Donors' elaboration of assessment criteria ranges from highly developed to little detail provided. France, the Netherlands and the EC provide assessment criteria for a country's performance measurement system.
Opportunity	Opportunity for sharing analytical assessment work among donors. Opportunity for cross-learning among donors about areas of focus and the elaboration of assessment criteria. Scope for development of a common information pool to inform non-financial risk assessment.

The evidence base for non-financial risk assessments

6.25 Donors commonly use the same evidence base for their non-financial assessments. Again donors vary in how much detail they provide in their assessment guidance on what evidence base to use. Annex F6 provides a summary of the evidence base used by the donors.

6.26 All donors advise their country teams to use information that is already in the public realm. The common sources of information are:

- partner government's own documentation and analysis;
- the donor's own analytical documents;
- other donor, international and local experts' analysis;
- civil society analysis;
- governance indicators.

6.27 The World Bank conducts a number of in-depth assessments, which are often used by other donors as inputs for their own analysis. (Although the WB is customarily the leader in these assessments, they are frequently joined and supported by other donors.) Such diagnostics that are used in other donors' assessments of non-financial risks include: Country Policy and Institutional Assessment, Country Environmental Analysis, Country Social Analysis, Strategic Environmental Assessment and Poverty and Social Impact Analysis.

6.28 The World Bank is the only donor that regularly undertakes primary research for its risk assessments. The guidelines show that other donors have scope for commissioning new analysis, (for example, DFID can commission bespoke country reports on political risk, the Netherlands can commission a corruption risk analysis by an external organisation), but it is not known from the information gathered how often this happens.

6.29 For the macroeconomic assessment, the satisfactory implementation of an IMF programme is seen as sufficient assurance of a stability-oriented macroeconomic policy. However, (with the exception of France[14]) the absence of a programme with the IMF is not taken by itself to mean that a stable macroeconomic framework is absent. Donors will assess the reasons for the status of the IMF programme and then make a decision on whether a stable macroeconomic assessment is in place.

6.30 The list of the indicators used for governance assessments by donor is detailed in Annex F7. The commonly used sets of international governance indicators are:

- Transparency International: Corruption Perceptions Index
- World Bank Institute: Worldwide Governance Indicators
- World Bank Country Policy and Institutional Assessment and IDA Resource Allocation Index (IRAI) (which is based on the results of the annual CPIA exercise that covers the IDA eligible countries).

6.31 The Netherlands and the UK guidelines include using benchmarks (Netherlands – World Bank Institute Worldwide Governance Indicators) and mandatory indicators (UK – a detailed list by criteria, see Annex F).

Key Commonalities	Donors are using the same evidence base for their non-financial assessments.
Key Differences	Donors vary in how much guidance they give on the evidence base.
Opportunity	Opportunity to share work on developing guidelines for evidence base. Opportunity for donors to share evidence base resources list at country level.

Donors' methodology for scoring non-financial risk assessments

6.32 There is a lot of variation in whether donors have a scoring methodology for their non-financial assessments. Some donors do for all their assessments, some donors do for some and others do not use scores. Whether a scoring methodology is used or not, all the donors provide guidelines on what approach to take to reaching conclusions on the assessment. In particular all the donors advise assessment teams to take into account both actual performance and the trend of progress. Individual donor approaches to scoring are set out in Table 6.4.

Table 6.4: Summary of donors' scoring mechanisms for non-financial risk assessments

Bilaterals	
Canada	The stocktake did not have information on Canada's detailed scoring for each assessment area.
France	No information.
Germany	Germany assigns the governance policy cluster assessed with a rating (on a scale of low to high performance) and provides guidelines on the calibration and application of their ratings.

[14] For "GBS for macroeconomic stability". Provision of "GBS in support of poverty reduction strategy" does not appear contingent on there being an operating IMF programme in the country.

Netherlands	The Netherlands has detailed scoring guidance for all of its Track Record policy cluster assessments The Netherlands does not score its sector-level assessment (Sector Track Record) as 'scoring implies comparability and this would require a more objective basis – including cross-country benchmarks such as CPIA scores – than is currently available.' (DEK, 2007a)
Sweden	Sweden provides guidance for interpretation of risk analysis, but does not assign scores to the assessment.
UK	The UK provides guidance for interpretation of risk analysis, but does not assign scores to the assessment.
Multilaterals	
AsDB	The AsDB has not guidelines or established methodology (at least publicly available) for quantitatively scoring risks. The GACAP II draft guidelines (2008) propose the following scoring system to rate the governance themes of PFM, procurement and corruption risks:: (1) Likely; (2) Relatively Serious; (3) Not mitigated over CPS period; (4) Major Risk (when all the previous are 'true').
EC	The EC does not score its risk assessment at country programming level. The EC programming tool "governance profile" is a qualitative assessment of governance supported by quantitative elements, in the form of scores, to standardise the process and facilitate comparability across countries. Each of the main weaknesses identified and that should be addressed is given a country specific weighting, reflecting their relative importance on the basis of the analysis of the situation. The level of relevance of the reform agenda of the partner country's governance action plan can be assessed as basic, intermediate, high or exceptional. A similar evaluation can then be made for the ambition and credibility criteria. (EC Interservice Quality Support Group) The EC GBS and Sector Support assessments do not have quantitative scoring guidance.
World Bank	The World Bank does not score its risk assessments, however its diagnostic tools have detailed scoring methodologies. To illustrate this approach: the World Bank assessment of governance aspects in the CPIA has a detailed scoring methodology; however in countries where governance is a central issue for poverty reduction, formulating and implementing the Country Assistance Strategy will be supported by appropriate diagnosis and feature governance as a central theme, in support of the county's own priorities, but there are a variety of ways to incorporate governance in country assistance strategies, with no 'one-size-fits-all approach'. (World Bank, 2007a)

Source: individual donor policies and guidelines – see Annex H for reference list.

6.33 Annex F provides further detail on the individual donor approaches.

Key Finding	Some donors score their non-financial assessments and some do not.
Opportunity	Opportunity for donor cross-learning on pros and cons of using scoring methodologies for different non-financial assessments.

Assessing the risks of corruption

6.34 All the donors covered by the stocktake are concerned with the risks of corruption. There are many drivers for corruption, and assessing the risks of corruption has to be informed by more than financial analysis. Assessments of governance, including institutional analysis and an analysis of 'political economy', are equally important.

6.35 Donors' arrangements and mechanisms for assessing the risks of corruption tend to vary – some require a separate specific assessment of the risks of corruption as part of the fiduciary risk assessment, others see it as being covered within the PEFA methodology. The World Bank puts considerable emphasis on assessing the standard of governance and anti-corruption and is in the process of implementing new guidelines. Donors' practices are set out in Table 6.5.

Table 6.5: Donors' approaches to assessing the risks of corruption

Bilaterals	
Canada	Fiduciary risk includes the risk of corruption with regards to CIDA funds. The risk of corruption more generally is included in the analysis of development risks.
France	The risk of corruption is covered by the various PEFA indicators in arriving at the overall rating of the level of risk. This will be supplemented by other diagnostic evidence when evaluating the level of fiduciary risk.
Germany	Corruption risks are not considered separately, but certain aspects in the good governance and PFM systems appraisals touch on corruption (e.g. does the government actively and effectively fight corruption; does it pay sufficient attention within the budget to transparency).
Netherlands	Corruption risk assessment is integrated in all instruments related to the activity cycle. There is a strong focus on the risk of corruption in completing the Track Record, which summarises the main corruption risks. The Strategic Governance and Corruption Analysis (SGACA) is the basis for the corruption risk assessment. A corruption risk management matrix can be used as an analytical base for the Track Record. In addition to the Track Record, Sector Track Records (STR) are developed for sectors in which an embassy is active. One of the sub questions in the STR focuses specifically on corruption. The operational way of dealing with inefficiency and corruption used in the context of aid effectiveness aims at comparing all benefits of alignment with all the risks thereof, leading to a broadly-based well-balanced decision.
Sweden	The risk of corruption is given a prominent place in assessments of the partner country's PFM system. Sida analyses the risks of corruption within the ambit of the country strategy programme. How this is done is assessed on a case-by-case basis. Sida policy is that it is important to assess the co-operating country's administrative system and the associated risks of corruption in development co-operation together with national auditing capabilities and practice. Close co-operation with the co-operating country and other donors through dialogue and shared studies is aimed for.
UK	A separate assessment of the risk of corruption, for which the country governance assessment is an important input, is carried out as part of the financial risk assessment. There is a separate framework for reporting this.
Multilaterals	
AsDB	Corruption is one of the three thematic governance priorities that must be risk-assessed: public financial management, procurement, and combating corruption. These three thematic priorities must be assessed for (i) national and sub-national government systems; (ii) AsDB priority sectors in the partner country; and (iii) AsDB programmes and projects in priority sectors.

EC	Country-level governance assessments include assessment of control of corruption. Each financing proposal should cover the risk of corruption, not just as it relates to PFM systems, but from an institutional perspective. The assessment should consider the extent to which the fight against corruption is on the agenda of the legislative and judicial power.
World Bank	The World Bank has recently increased its focus on governance and anti-corruption and is developing new guidelines for assessing these issues at country level.

Source: individual donor policies and guidelines – see Annex H for reference list.

Key Commonalities	Each donor is concerned with assessing the risks of corruption, and from a wider standpoint than weaknesses in PFM systems.
Key Differences	Donors differ in how they assess the risks of corruption, both in the extent to which corruption risks are incorporated in PFM assessments, and in the variety of strategic (governance and) corruption assessments that are emerging.
Opportunity	There is an opportunity for donors to coordinate their approaches to assessing the risks of corruption. In the process, there is an opportunity to share their understandings of the different types of corruption risk that apply (e.g. in different sectors) and hence the different mitigation measures that may be appropriate.

All assessments: recent and planned changes

6.36 As donors have committed to using country systems when the circumstances are right and programme-based approaches have become increasingly common, donors have (further) developed financial risk assessments and governance assessments[15] to inform their use of country systems. These assessments have been introduced by some donors at the country level in recent years. Table 6.6 summarises some of donors' work in developing assessments at the country level.

Table 6.6: Developments in country level risk assessments

Bilaterals	
Canada	Country programme level Fiduciary Risk Assessment introduced 2007.
France	No information on recent or planned developments in France's risk assessment approach.
Germany	PFM risk assessment guidelines were developed in 2006 for programme-based approaches.
Netherlands	Track Record assessment extended from just budget support to all aid modalities in 2005. Strategic Governance and Anti-corruption Assessment introduced 2007.
Sweden	Sida is developing a draft terms of reference for overall PFM analysis in connection with an assessment of proposed general budget support
UK	Country Governance Analysis introduced 2007 and country-level Fiduciary Risk Assessment issued in January 2008. DFID is undertaking several specific steps to make political risk assessment and mitigation even more robust. At the country level, DFID is revising the guidance

[15] The OECD DAC GOVNET Survey on Donor Approaches to Governance Assessment (Nils Boesen, 2008) highlights this same trend, identifying that 18 agencies are using 30 different tools to assess governance, with a further 16 tools under development.

	for the Country Assistance Plan. A framing paper requires that (political) risk analysis is sufficiently covered. Country governance analyses remain a mandatory annex to the country assistance plans and efforts are under way to further strengthen the consideration of political risk. Another activity is that scenario and contingency planning is currently being completed for a limited number of fragile states (Contingency Planning Pilot Programme) in which DFID is scaling up its work to help ensure that DFID is aware of and prepared for changing situations in high risk environments. These plans aim to combine short term and long term factors and ask questions that contribute to best understanding of risks, opportunities and mitigation strategies (including working with other donors).
Multilaterals	
AsDB	AsDB is implementing initiatives to enhance its risk management capabilities, by establishing and enforcing clear policies and procedures for independent risk assessment and management. The draft Second GAC Action Plan (GACAP II, 2008) introduces a risk-based approach to managing governance and corruption risks. The requirement for mandatory country governance assessments is removed and is replaced by acquiring up to date country and sector knowledge on governance, institutional development and on how to prevent corruption. From 2006 AsDB started phasing in requirement for risk assessments and risk management plans during the formulation of country strategies and the preparation of projects in partner countries where ADB has a lending programme.
EC	Governance profile introduced in 2006. GBS and SBS assessment guidance revised 2007.
World Bank	Re-invigorated focus on governance and corruption at the country strategy level (not a new governance assessment), with the March 2007 Board endorsement of the paper "*Strengthening World Bank Group Engagement on Governance and Anticorruption*". (World Bank, 2007b) The 2007 status report on use of country systems reported that the World Bank is encouraging greater integration of work on Country Financial Accountability Assessments, Country Procurement Assessment Reports, and Public Expenditure Reviews. In several countries these diagnostic exercises have been combined into a single, integrated review. (World Bank, 2005)

Source: individual donor policies and guidelines – see Annex H for reference list.

6.37 Another area of recent or planned developments in risk assessments is at the sector level. Donor guidance on assessments for sector level programmes varies widely. The Netherlands, Sweden, the Asian Development Bank and the EC have developed or are developing sector-specific guidance:

- The Netherlands 2007 revised Track Record contains new requirements to feed in the analysis of the Sector Track Record (STR, introduced also in 2007). The Netherlands position their STR as work in progress towards a multi-stakeholder analytical and monitoring instrument:

  > The intention is *not* to impose any blueprints on our development partners. The STR is 'work in progress' towards a multi-stakeholder analytical and monitoring instrument, and prior to the subsequent round of full STR analysis – presumably 2011 – the lessons learnt with respect to suitability for joint work will be taken into account. (DEK, 2007a)

- Sweden is developing sector guidance for PFM analysis in the context of a sector programme.
- In contrast to the Netherlands approach in particular, the Asian Development Bank approach is for the risk assessments for national/subnational systems to inform the risk assessments at sector level, which in turn inform the risk assessments at the AsDB program and project level;

- The EC issued revised sector assessment guidance in 2007 (EuropeAid, 2007) to strengthen and clarify the message on SBS as the preferred modality for EC support to sector programmes; making the eligibility criteria for SBS explicit and ensuring coherence with the revised guidelines for GBS. In addition EuropeAid is currently developing methodological guidance to assist delegation staff and partners to mainstream and specify governance issues at sector level (*ibid*.).

6.38 Further research is required to ascertain whether the assessment requirements for individual programmes have been revised in order not to duplicate work undertaken at the country and strategy level. Of the donors covered, the Netherlands, the Asian Development Bank and the EC stand out as having clearly articulated links between different levels of assessments.

Key Commonalities	Many donors have recently introduced or further developed their country level fiduciary risk assessments and governance assessments.
Key Differences	Some donors have developed detailed guidelines for sector assessments.
Opportunity	Recent moves towards undertaking country level assessments to inform decisions on the use of country systems provide donors with a new opportunity for harmonisation. An opportunity to check that new country-level assessments are coordinated with requirements for individual aid programme assessments to avoid any duplication of effort. Sector level assessments may be another area with scope for cross-learning and harmonisation – opportunity to build on current processes in sectors where sound and comprehensive joint sector appraisal and review processes are in place.[16] It is an opportunity to try tailor-made approaches in different countries, in different sectors. There is an opportunity to ensure that partner governments, and other partner country stakeholders, are appropriately engaged in such assessments.

All assessments: evaluating risks

6.39 Most of the donors in the stocktake provide guidelines on how to evaluate the risks identified. Most evaluate the risks in terms of the likelihood of the risk being realised, and the impact if the risk is realised. Some rate the risks before the application of mitigating strategies, others afterwards. Some examples of the different approaches include:

- Germany rates the overall risk of a programme and also gives a rating to what extent the risks can be influenced or managed.
- Canadian guidelines for risk quantification use the probability/impact assessment approach (see Figure 4.3) to

> Support a calculation of the possible cost of the potential external risks and/or the amount required for an external risk allowance within the overall budget. Costing is undertaken by:
> - Estimating the cost of additional inputs required to compensate for the occurrence of each specific risk;
> - Assessing the total estimated cost of mitigating all risks; and,

[16] The Strategic Partnership with Africa (SPA) is considering a stream of work proposed by the Netherlands, to work towards joint sector assessments, based on the Netherlands' experience with its Sector Track Record (DEK, 2007b).

  - Determining the extent to which this total should be discounted in view of the probability (or lack thereof) of several risks being activated during the life of the project. (Canadian International Development Agency, 2008).

- The Netherlands evaluates likelihood and impact, and picks out the following criteria which should be taken into account when calculating the severity of the impact of a risk: direct impact versus indirect impact, impact on efficiency versus impact on effectiveness, economic value lost and impact on reputation.
- The World Bank rates probability of occurrence and the level of impact of the risk after the (presumed successful) mitigation strategy – referred to as the residual risk.

Key Findings	Some donors evaluate risks systematically, usually in terms of likelihood and impact.
Opportunity	Scope for cross-learning on effective approaches to evaluating risks.

7. Addressing Risks

Introduction

7.1 This chapter looks at the ways in which risks that have been identified and assessed are addressed (the terms are those used in the risk management model in Figure 4.2). Successive sections of the chapter deal with:

- the generic ways of addressing risk;
- donors' individual approaches to addressing risks;
- donor approaches to sharing risk.

7.2 The chapter demonstrates the wide range of actions that are (at least in part) a response to perceived risks. It cannot deal with all the possible variants, or their technical merits, but it does highlight how they may interact with each other, the scope for confusion in the ways that different mitigation measure impact on partner governments and hence the scope for shared learning and collaboration among donors.

Generic ways of addressing risk[17]

7.3 The different ways of addressing risk can be applied at **strategic**, **programme** and/or **operational** levels (cf. Figure 4.1).

7.4 At all management levels, if a risk is identified, donors can decide to **tolerate** risks if the impact of the risk is moderate or the ability to do anything about it is limited or if the cost of taking action is disproportionate to the potential benefit gained. However, some risks are judged too great to be taken and the only option is to **terminate** (or not start) the associated activity. Other risks may be **treated**: i.e. the inherent risk is considered too great to tolerate, but action can be taken to constrain the risk to an acceptable residual level. Such actions are known commonly as “mitigating measures”.

7.5 In a standard risk management model, it is also possible to **transfer** risks (e.g., through conventional insurance or paying a third party to take the risk in some way). It is not possible for donors to transfer their risks entirely. However, it is possible for donors to share risks with other donors, which is another way to address risks. (Donors may also require partner governments to bear some of the risks – e.g. in their responses to breaches, discussed in Chapter 8.)

7.6 A fifth possible response to risk is to **take the opportunity**. This is not an alternative to other ways of addressing risk but arises when the same circumstances that give rise to a negative threat also represent an opportunity to exploit positive impact. (The opportunity to support a weak post-crisis state might be an example.)

7.7 All five ways of addressing risks can be undertaken by donors jointly or separately. Working jointly may be a way of:

- reducing transaction costs, and sharing benefits of analysis as a common good;
- sharing risks;
- increasing the effectiveness and efficiency of joint mitigation strategies.

[17] The following classification is adapted from HM Treasury, 2004.

Donors' approaches to addressing risks

Overview

7.8 Donors have an overall policy on whether to use country systems. Their strategic "risk appetite" for taking the risks involved in using country systems is set by this policy. Donor policy sets parameters for which type and level of risks will be tolerated, treated or terminated. Donors' general (strategic) policies for using country systems have been set out in Chapter 3.

7.9 A donor's policy on using country systems is interpreted at programme level through assessment of eligibility criteria for the provision of aid using country systems. This assessment is then used to inform the decision on the composition of the donor's aid modality portfolio for the country. The aid portfolio includes the capacity-building inputs that the donor will use to complement the aid programme.

7.10 Risks are addressed at the operational level in the design and then the monitoring of individual interventions. When breaches occur they may be dealt with at operational level, but if serious may have programme and strategic implications. (See discussion in Chapter 8.)

7.11 All donors emphasise the need to identify the risks early on not only to choose the right aid modality to achieve the sought-for results but also to design the aid instrument appropriately in order to manage the risks identified.

7.12 All donors identify a wide range of measures that can be used to mitigate risk. No donor systematically links individual risks to mitigating measures. The Netherlands goes furthest in this direction, having developed typologies of corruption in two sectors (health and education) which set out the type of corruption practice, impact on the sector, root causes and mitigating measures. Sweden also provides some examples of mitigating measures for common risks in the areas of PFM and corruption.

7.13 Many of the donors (the Netherlands, the UK, the EC, the Asian Development Bank, the World Bank) use risk management templates to facilitate mitigation planning. For example, the Asian Development Bank has risk management plans which explicitly address how major risks (risks that are likely to occur and are relatively serious) are to be addressed (while recognising that its resources, instruments and influence are limited and therefore it cannot address all risks identified during the risk assessment exercises, especially in overall high-risk countries). Table 7.1 shows another example – the Netherlands' risk management matrix.

Table 7.1: Example of risk management matrix

Activity # / Process: ***description of activity / outcome or process***				
Risks	**Potential adverse impact**	**Risk level (H/M/L)**	**Risk management strategy**	**Monitoring**
Describe the situation / part of the activity where there is a high chance of corruption	*Description of adverse impact*	*Likelihood that situation will take place times level of impact*	*Description of mitigating measures*	*How will the risk be monitored?*

Source: DEK, 2007b.

Eligibility criteria

7.14 A donor will identify the risks involved in the particular country context and decide whether those risks are tolerable, or if not tolerable then treatable, through assessment of the "eligibility criteria".

7.15 All the donors assess the eligibility of partner governments to receive aid that uses country systems. Donors use similar eligibility criteria that can cover: the national public financial management system, the national poverty reduction strategy (PRS) and the government's commitment to its PRS, the country's macroeconomic framework and the governance dimensions. There are some significant variations in the focus of donors' eligibility criteria, which are shown in Table 7.2.

7.16 A particular variation is that donors' eligibility criteria related to assessments of PFM systems carry different levels of emphasis. This seems likely to lead, in practice, to differences in the extent to which donors rely on partner country systems.

7.17 When assessing government performance against the eligibility criteria for using country systems, the donors in the stocktake do not have absolute "thresholds" in the sense that pre-set minimum conditions have to be met.[18] Donors commonly consider a government's commitment to reform. Some donors set minimum scores for the eligibility requirements (Germany) or the appropriate alignment ceiling (Netherlands). These minimum scores are not the same as rigid thresholds as both the country context and developmental path are taken into account when scoring the assessment. Swedish guidelines sum up this approach well:

> Specifying a minimum level of assessment criteria that must be met in each case if Sweden is to provide budget support is not feasible. Sida, therefore, must make a point of carefully documenting how the overall assessment has been arrived at. (Ministry for Foreign Affairs, Sweden, 2005).
>
> Hence, the task is not primarily to judge whether the systems are good enough or meet predefined criteria, but whether our support (e.g. to a sector programme or PRS) can effectively contribute to poverty reduction. Obviously, the answer to that question can be negative if the PFM systems are weak, but that conclusion should not be drawn on account of the identified weakness per se, but from limited prospects of addressing these development problems effectively. (Sida, 2007)

7.18 Donors do not appear to prioritise eligibility criteria. The typical guidance is:

> The … eligibility criteria should be seen as part of a coherent and interdependent whole. It would be inappropriate to judge non-performance in one area as being offset by good performance in another area. Instead, performance in all areas is seen as key to ensuring eligibility for budget support. (European Commission, 2007)

7.19 Not all donors have clearly set out their criteria for using country systems in practice. Each donor may have a different appreciation of the level of risk it is prepared to tolerate in using country systems. Donors have not explicitly set out, or attempted to quantify, this level of risk. As a result, their central procedures for managing aid flows may not be consistent with the overall policy of increasing the use of country systems. For example, in its October 2007 Status Report (World Bank, 2007b), the World Bank recognised that it is operating in a high risk environment and that risk assessment exercises should recognise this; at the same time it recognised that its pre-requisite for using country systems – 'equivalence' to World Bank systems[19] – is a 'very high standard' and has 'discouraged involvement for a number of countries'.

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[18] With the exception of the World Bank which does have a threshold for individual programmes (excluding Development Policy Lending). See Table 7.2 for further details.

[19] For programmes other than development policy lending.

Table 7.2: Overview of donors' eligibility criteria

Donor	Public Financial Management System	National Strategy	Macroeconomic Framework	Governance
Bilaterals				
Canada	Information not available.			
France	A positive evaluation of the PFM system based on the assessment of fiduciary risk. Evaluation of risk evolution (improvement, deterioration, stable) and the credibility of government's commitment to reforms will also influence decision-making.	A national growth and poverty reduction strategy, consistent with the MDGs, and a functional system for monitoring and evaluating its performance.	Sound and sustainable macroeconomic policy.	
Germany	A satisfactory score from PFM systems analysis and confirmation that risks can be suitably managed through reform and/or capacity building measures in the medium and long term (and through safety measures in the short term).	A clearly positive trend in the development of the partner country. The political will should be above-average.	Stable macroeconomic conditions.	At least 'medium' partner country score on all the established governance criteria – and 'high' score for one of them.
Nether-lands	Rather than individual eligibility criteria, the Track Record (TR) has 4 policy clusters (poverty reduction. economic management, good governance – PFM and basic conditions, dialogue). Each is scored. Overall score determines alignment ceiling. Mission then proposes aid portfolio of different aid modalities. Scoring system for overall score shown below. Scoring for individual policy clusters shown in appropriate cells below. Low scores do not automatically lead to non-alignment if in a structured analysis (e.g. the multi-annual strategic plan) a positive trend can be discerned or made plausible in terms of reduction of fragility, improvement of security or basic conditions for poverty alleviation; the Minister may then opt for higher levels of alignment than -technically- warranted by the TR. Fully aligned: - General budget support (including via IFIs) - Sectoral budget support → - Dialogue at least satisfactory - All cluster columns satisfactory - No more than two sub clusters unsatisfactory - No 'd' (i.e. bad) scores Partially aligned: - All other forms of programme aid (except budget support) → - No more than two clusters unsatisfactory and no 'd' scores - No more than four sub clusters unsatisfactory - No more than one 'd' score for the sub clusters Not aligned: All forms of non-programme aid → - More than two clusters unsatisfactory, or - More than two sub clusters awarded a 'd' score However, if risk analysis of PFM shows risk providing GBS too high, country not eligible.			
Sweden	Prior to decisions on general budget support, special note should be made of the presence or otherwise of transparent and sufficiently effective systems for PFM, and of the country's efforts to strengthen these systems. Assessments should consider the actual situation and current development trends, as well as any reforms that may be under way.	Of importance for Sweden when considering support is whether the country's PRS is of good quality in terms of preparation, content and implementation.	Another requirement when considering general budget support for poverty reduction is that the country in question is pursuing sound economic policies which are sustainable in the long term.	
UK	Partner country must be committed to strengthening PFM and addressing corruption (one of the three partnership commitments).	The partner government must be committed to reducing poverty		The partner government must be committed to upholding and progressively realising human rights and international obligations

Donor	Public Financial Management System	National Strategy	Macroeconomic Framework	Governance
Multilaterals				
AsDB	AsDB's policy requires executing agencies to maintain a financial management system that ensures accountability, efficiency, economy, and solvency. AsDB will rely on partner country systems for procurement and PFM when the partner country has implemented mutually agreed standards and processes	In general, the AsDB's approach is that it will establish, in consultation with partner countries, mutually acceptable performance criteria for moving to country PFM systems	General macroeconomic conditions and the direction of macroeconomic policies must be deemed satisfactory	In general, the AsDB's approach is that it will establish, in consultation with partner countries, mutually acceptable performance criteria for moving to country PFM systems
EC	Credible and relevant programme of improvement in PFM is in place and PFM is "sufficiently transparent, reliable, and effective" always taking into account that "sufficiently" is given a dynamic interpretation	A well defined national (or sectoral) policy and strategy that responds to the challenges and problems faced by the partner country is in place/under implementation.	The macroeconomic policy is conducive to maintaining macroeconomic stability over the coming years.	
	The EC advises: Whenever looking at the eligibility criteria, it is always important to take into account the direction of change. In the use of budget support there are no absolute "thresholds" in the sense that certain static minimum conditions in the area of national policy and strategy, macroeconomic policy, and public financial management have to be met. Instead, the key factor in deciding whether eligibility criteria are met is the direction and magnitude of change against the background of the initial quality of the national development or reform policy and strategy, the macroeconomic framework, and PFM.			
World Bank	Financial arrangements must be acceptable, defined as: (i) capable of correctly and completely recording all transactions; (ii) facilitating the preparation of regular timely and reliable financial statements; (iii) safeguarding assets; (iv) subject to auditing arrangements acceptable to the Bank. These requirements are generally referred to as 'equivalence' to Bank systems. For individual operations, the Bank has a risk threshold that is the pre-defined level of maximum acceptable residual risk above which specific interventions are called for. *Development Policy Lending*: Development policy support can be provided in a country that has a weak public financial management environment but has committed itself to an adequate program of public financial management improvement and there is reasonable evidence that improvements are occurring in a timely manner.	*Development Policy Lending*: A government has to achieve the relevant thresholds indicated in the CAS, including a sufficient indication of ownership of the associated reform program in broad terms	*Development Policy Lending*: Appropriate macroeconomic policy framework	Governance ratings (included in the CPIA) do not affect absolute eligibility, but do affect the size of the programme. "According to the Bank, the CPIA is designed to systematically allocate scarce IDA resources, channeling aid to more effectively promote sustainable growth and poverty reduction. IDA aid is distributed on the basis of the country performance rating (CPR) and, to a lesser extent, country need. The CPIA score is key, as it makes up 80% of the country performance rating. The other 20% is a rating of the Bank's ongoing projects in country. The sum is finally scaled up or down by a "governance factor," an indicator of the country's governance quality." (The Initiative for Policy Dialogue, 2007)

Source: individual donor policies and guidelines – see Annex H for reference list.

7.20 There will be an unintended bias against use of country systems in practice, if the eligibility criteria applied at operational level are stricter than is consistent with an agency's strategic appreciation of the importance of using country systems.

Key Commonalities	All donors have eligibility criteria for assessing whether to use country systems.
Key Differences	Donors do not always set out these criteria in a transparent fashion. Donors' eligibility criteria for assessing PFM systems carry different levels of emphasis which may lead, in practice, to differences in the extent to which donors rely on partner country systems.
Opportunity	Opportunity to use clearer definitions in transparent explanations of eligibility criteria. Opportunity to check for unintended bias against use of country systems.

Aid modality portfolio

7.21 Donors choose which modality (or combination of aid modalities) to use to achieve the sought-for results, while balancing the potential benefits with the risks identified. This choice will be informed by the donor's strategic policy on using country systems and the preconditions expected that are set out in the donor's eligibility criteria.

7.22 Donors' guidelines on how to choose the right modality mix and the right instruments (including general budget support, sector budget support, pooled funding, projects) are varied in terms of detail and emphasis:

- A number of donors (the Netherlands, Sweden, the UK and the EC) provide guidelines on how to choose between different aid modalities.
- The Netherlands has a clear approach to determining an aid modality's degree of alignment; it provides guidance on alignment disaggregated to three levels: 'on plan', 'on budget' and 'on treasury' (cf. Box 2.2 above).
- Other donors surveyed do not unpack the concept of using country systems so systematically in their guidance on which aid modalities and instruments to use.

7.23 Guidance on the benefits and risks of individual aid modalities and instruments varies in level of detail. Some of the donors advise that risks associated with budget support are not a priori greater or smaller than those associated with other instruments:

> There is no a priori reason to believe that the risks associated with budget support are greater or smaller that those associated with other aid modalities. (European Commission, 2007)
>
> Many risks apply to the whole aid programme and to projects just as much as to budget support. (DFID, 2008c)

7.24 However, all of the donors in the stocktake perceive that the risk profile changes when using country systems. Some risks are seen as being unique to using country systems (and in particular the provision of budget support). These are most commonly fiduciary and governance risks:

> Some risks, like those related to public finance management and fiduciary risks might become more important. (European Commission, 2007)
>
> Budget support is more susceptible to political governance and some fiduciary risks. (DFID, 2008c)

7.25 Fewer donors also advise that some risks may diminish when using country systems:

> Others, such as weak policy environment and lack of ownership, lack of co-ordination and weak result culture, diminish as they are directly addressed by using budget support. (European Commission, 2007)

7.26 Donors assess the risk involved in different dimensions of the budgetary and financial management systems and choose the appropriate aid modality for the level of risk identified. If a donor identifies that the full use of country systems has an unacceptable level of risk, then one option for donors is to use what they see as intermediate aid instruments.

7.27 Some of the donors emphasise that (targeted) sector budget support is an effective way of delivering aid using country systems in countries where risks are high. For example, the UK's guidance is:

> Fiduciary risk can be managed if we track our resources to the individual sectors so we can demonstrate more directly how they are spent and how they complement the government's own resources. (DFID, 2008c)

7.28 All donors see pooled fund arrangements as an alternative way of providing aid to a sector, when the risk (particularly fiduciary risk) is too high to give sector budget support. In turn many donors will use projects to support sector programmes when the fiduciary risk is too high for pooled funds. This suggests a sliding scale of risk from budget support to stand-alone projects. However, some of the donors (the Netherlands, Sweden, the UK and the EC) emphasise that there is no standard evolution from project aid through sector programme aid to general budget support. They also contend that achieving a complementary aid portfolio is an important mitigating strategy, for two main reasons:

- Combining instruments, including different financial aid instruments, may help reduce risks, both for donors and for partner governments, by reducing reliance on any single instrument.
- In some cases the positive effects of budget support can be cancelled out by the deployment of other aid modalities, especially when they are not aligned to the national budget.

7.29 The Netherlands' guidelines stress that complementarity is important not only within the individual donor development effort, but also among the donors active in a certain country. In particular, Sweden, the UK and the EC provide guidance on how the provision of general budget support and sector support (through sector budget support and pooled funding) can be complementary. Key points in this guidance are:

- SBS can complement GBS by providing more predictable finance to the budget. Provided eligibility conditions are satisfied, disbursement of SBS funds can continue even if the implementation of a GBS programme is delayed or temporarily suspended.
- SBS provides access primarily to policy dialogue at a sector level, while general budget support provides access primarily to dialogue at the highest level.
- SBS and other sector financial aid might be used alongside GBS to encourage line Ministries to support central reform efforts (and central Ministries to support sector reform efforts).

7.30 Some donors also stress the importance of assessing the merits of using pooled funds and projects within a sector programme on a case-by-case basis, which highlights the possible costs and benefits of both modalities. The EC has developed guidelines for this (see Box 7.1).[20]

Box 7.1: EC guidelines on choosing between pooled funds and project modalities

The choice between pool funding and project modalities should be based on a case-by-case basis. This entails a detailed assessment of how costs and benefits vary under each option. In general, project procedures will tend to be favoured where the up-front preparation costs of a pool arrangement are considered prohibitive; or the potential benefits from harmonising procedures are limited; or the fiduciary risks in pool funding are considered to be too high, or a combination of all of these factors. …

A proposal to proceed on the basis of a joint/pooled approach needs to show that the relationship between expected benefits and potential costs is significantly more favourable when compared to the standard project approach.

A further important consideration on the potential costs side of the assessment is the different exposure to fiduciary risk under the pool fund and the project approach. This is of particular importance in cases where the pool fund is managed by the beneficiary. In the sense of the Financial Regulations, such cases entail a greater degree of decentralised management than the standard project approach. Consequently, greater attention needs to be paid to the assessment of the financial circuits at the appraisal stage of pool funds. This in itself implies an increased burden of preparation costs. Moreover, the risk profile will most likely be different under each modality and this should be explicitly considered as a potential direct cost when assessing the choice of modalities.

Source: EuropeAid, 2007.

Complementary capacity-building inputs

7.31 Capacity building is seen by all donors as a critical element of their support to partner countries and all donors see it as part of the package of support, complementary to the provision of budget support. Donors adopt a long-term strategy, underpinned by a programme of capacity-building support to assist partner countries in improving their systems (public finance management and good governance more generally). The World Bank's recent Implementation Plan for Strengthening Engagement on Governance and Anti-corruption (World Bank, 2007a) recognises the need for the World Bank's 'governance and anti-corruption interventions' to support greater development effectiveness.

7.32 Capacity building is identified as one of the key elements in addressing risks, in particular fiduciary risks and the risk of corruption. Capacity-building support to government-led reforms to strengthen public financial management systems is an important risk-mitigating measure for all donors. Many donors (including the Netherlands, Sweden, the UK, the Asian Development Bank, the EC, the World Bank) also stress the need to provide support to the demand side of governance and strengthening domestic accountability structures, such as parliaments, supreme audit institutions, civil society organisations, and the media (see ¶7.34 below).

7.33 The donors highlight that achieving sustainable results in the area of institutional and capacity development is one of the most difficult aspects in development cooperation. Good practice guidelines provided by donors include:

- All donors emphasise the need for the reform programmes to be country-led and advise that donor support to such processes is only likely to produce significant and

[20] Many pooled funds do not use country budget systems (e.g. disbursement through Treasury) – in some cases, bypassing government systems has been part of their raison d'etre. Although they may be portrayed as a stepping stone towards the use of country systems, they often seem, in practice, to suffer many of the drawbacks of other parallel approaches. (Mokoro, 2008b; Williamson and Kizilbash Agha, 2008)

sustainable results as long as there is sufficient domestic political leadership and commitment to change.

- Many donors call for a harmonised approach to capacity building. For example, the EC stresses the need to avoid the danger of a shopping list of "needed" inputs and recommends that

> A structured dialogue and a phased approach involving all main stakeholders be undertaken in the country so as to reach broad agreement on the nature of any institutional and capacity development support. (European Commission, 2007)

- Some of the donor (Sweden, the UK, the EC, the World Bank) guidelines underline the importance of good practice in: setting an appropriate pace and timing of reforms; not overloading budget support with issues that are not necessarily central to its objectives; and adapting to available implementation and absorption capacity in its many dimensions. (European Commission, 2007)

7.34 Some donors (the Netherlands, Sweden, the UK, the EC, World Bank) highlight that, with budget support in particular, and with other forms of aid using government systems, there is a danger of "vertical accountability" of government to donor usurping domestic accountability. To mitigate this risk, many of the donors use capacity building and policy dialogue to strengthen local accountability structures and support the demand side to good governance from civil society organisations and the media. The donors in the stocktake generally call for harmonised action in planning and implementing capacity building programmes. However, they do not specify how this will be done in the case of such initiatives with civil society which may be outside the performance assessment framework and therefore harder to coordinate and monitor.

Monitoring and dialogue

7.35 All donors view monitoring and dialogue with the partner government as essential elements in addressing risk, especially when using country systems.

7.36 Donors monitor risks by monitoring performance against the performance/progress indicators. Donors have regular reviews during each programme (commonly a joint annual review). Donors also monitor the implementation of their mitigating strategies to see that identified risks are being adequately managed and to identify any new risks or changes in circumstances. Most risk assessments are updated annually.

7.37 Donors provide different levels of detail in their guidance on how to design effective indicators. Some donors stress the good practice of using the country's own monitoring system. France has as one of its eligibility criteria "a functional system for monitoring and evaluating its performance." Other donors flag up the importance of an ex-ante assessment of the partner government's monitoring system as part of their risk management strategy.

7.38 For all the donors, an effective dialogue with the partner government is critical for aid coordination and risk management, and is a key complement to the financial flows of aid provided to government and using government systems. In particular dialogue provides donors (and government) with an opportunity to manage emerging risks. The focus of the dialogue is provided by the choice of performance criteria. Through dialogue, the ideal is for the partners to avoid suspension of aid:

> The outcome of the dialogue, much more than whether or not an indicator is met, can come to play a decisive role in the disbursements of funds. (Nordic Plus, 2007)

7.39 In their guidelines on risk management all the donors underline that maintaining a closer policy dialogue with the government is a central feature (and result) of providing aid that uses government systems. In particular general budget support is accompanied by dialogue on overall policy and strategy and the functioning of PFM, as it contributes to the country's overall budget envelope. This "wider" policy engagement with partner governments is more than a risk management strategy: it is recognised by donors to be one of the key benefits of providing budget support.

7.40 Many of the donors provide good practice guidelines for setting up an effective dialogue. Some of the key points that the donors stress are:

- regular consultations are important
- dialogue is important at both the design and implementation phase of the programme
- use can be made of both formal and informal processes
- early dialogue on worrying trends is important.

Disbursement conditions

7.41 All the donors in the stocktake use conditionality as a way to mitigate risk when using country systems. Each donor attaches conditions for disbursements of their aid, which will for the most part focus on eligibility criteria, but may also cover other particular risks identified during the risk assessment.

7.42 Many of the donors distinguish between general and specific conditions for disbursement when using country systems. The general conditions are drawn from the eligibility criteria and apply to all payment decisions. There is a lot of commonality among the donors in terms of which general conditions they use. In particular the bilateral donors in the stocktake have a common set of fundamental principles which include:

> … good governance, democratic principles, respect for human rights and the rule of law. These fundamental principles are prerequisites for cooperation and support. Violation of these principles may have consequences for the continuation of donor support to the national plan/programme. (Nordic Plus, 2007)

7.43 Donors include in their guidelines the good practice of communicating general conditions clearly to partner governments, in harmonised Memoranda of Understanding (MOUs) and Codes of Conduct. The EC cautions that it is important to draft the general conditions in a way that does not introduce formalistic rigidities that may lead to unnecessary "stop and go" during programme implementation.

7.44 Specific conditions apply to the disbursement of individual tranches (which can be fixed or variable)[21] and are attached to the programme's key performance indicators. There are two risk-mitigation measures here:

- Not explicitly stated by donors, but it can be inferred that donors link good performance to disbursement conditions because they believe it will encourage and/or reward good performance. (See example in Box 7.2)
- By monitoring performance indicators donors can check that the programme supported is progressing towards the achievement of its objectives.

[21] A common definition of fixed and variable tranches: **Fixed tranches** have a fixed value. They are either disbursed in full (if all conditions are met) or not at all (if one or more conditions are not met). **Variable tranches** have a maximum value. They are either disbursed in full or in part, with the amount being disbursed being based on performance achieved in relation to pre-specified targets or designated performance criteria and indicators (provided that at the same time the general conditions are all met). (European Commission, 2007)

7.45 There are some differences in donor guidance on the design of performance indicators. Most of the donors in the stocktake group advise that disbursement performance indicators can be policy actions (when led by governments), inputs, outputs or outcomes. The EC strategy is to ensure that the indicators are "result/outcome-oriented". At the same time donors also have a lot in common in their approach to performance indicators:

- performance indicators should ideally be drawn from the government's poverty reduction strategy.
- performance indicators should be harmonised in a single matrix (often called a performance assessment framework (PAF))
- performance indicators in the PAF should be limited in number, reflecting only those crucial to the government's implementation of its program.

7.46 Disbursement conditions for performance indicators are commonly used with variable tranches. Germany, France, Sweden, the UK and the EC advocate the use of fixed and variable tranches. The EC sets out clearly the rationale for this approach, which is shown in Box 7.2. Swedish guidance underlines that:

> Deviations between goals and outcomes are always to be expected. The linking of all or parts of the support to results, therefore, should not be done automatically but be based on a qualitative assessment. (Ministry for Foreign Affairs, Sweden, 2005).

Box 7.2: Rationale for disbursement conditions linked to variable tranches

- *Partial payment for partial performance.* It seems more "just" or appropriate to recognise progress that has been made on certain conditions, even when progress has not been made in all areas. In effect a "reward" for some performance seems more appropriate than not making any payment at all.
- *Avoid damaging "stop-go" in aid disbursements.* The idea that all tranches should be disbursed on the basis of "all or nothing" can be particularly damaging to macroeconomic and budget management. The opportunity of providing a partial disbursement opens up the possibility of avoiding these potentially volatile and damaging swings in support.
- *Enhanced credibility of disbursement conditions.* Often because of the damaging "stop-go" effects mentioned above, donors are tempted to overlook under-performance by granting waivers, thus ensuring that the whole amount of a tranche payment can be made rather than blocking the payment. There is a risk in this approach - if it becomes too frequent it will undermine the credibility of conditionality. This credibility can be maintained by making partial payment for partial performance.

It is worth observing that other donors often use a de facto variability in their tranches, through a process of altering commitments and disbursement that are set on an annual basis. This is the approach adopted, for example, by the World Bank in its programmatic lending where "in the case of uneven country performance, the Bank has typically reacted either by delaying the next operation or reducing its amount"

Source: EuropeAid, 2007.

Short-term safeguards

7.47 All the donors envisage the use of short-term safeguards as a risk-management strategy. However, not all donors use the term "short-term safeguards" and there is no shared standard list of safeguards. Some donors use safeguards but do not categorise them separately from their other risk-mitigating measures. The Joint Financing Arrangement (JFA) guidance is shown in Box 7.3.

Box 7.3: JFA guidance on safeguards

Introduction to the Joint Financing Arrangement (JFA)

¶1. The JFA has been designed as a tool to help aid practitioners involved in multi-donor cooperation. … Because of its versatility and flexibility, the JFA can be used for a broad range of aid modalities (budget support, the pooling of funds or projects). The checklist, template and Guide have been approved by representatives of the following countries: Canada, Denmark, Finland, Ireland, Iceland, the Netherlands, Norway, Sweden and the UK.

Gradual approach in reaching full alignment

¶6. Harmonisation and alignment are major underlying principles essential to the design of JFAs, and the ideal would be to fully align donor support with the partner government's budgetary and accountability system and legislation. In practice, it is not yet often possible to achieve full alignment and a more gradual approach is taken in order to contain and manage risks. In particular, in the case of budget support to countries whose budgetary and accountability systems and legislation do not meet or do not fully meet the minimum international accepted standards, it will be necessary to include provisions in JFA on such safeguards as additional reporting or parallel systems on other specific items to mitigate and manage donor risks.

Source: Nordic Plus, 2007.

7.48 The UK provides long lists of the possible safeguards that can be used by donors (DFID's list is summarised in Box 7.4). DFID stresses that the use of safeguards should be designed to be temporary (hence the use of "short-term" safeguard), and that parallel efforts should be made to support and develop the government's own systems. DFID presents the lists of safeguards not as recommendations, but as a summary of the types of measures which have been used by donors.

Box 7.4: Types of safeguards used by donors when using country systems

- Enhanced information flows required by donors
- Capacity enhancements related to financial management
- Use of control / coordination units
- Direct channelling of donor funds to implementing agency, by-passing central intermediaries who may be weak
- Additional audit scrutiny
- External scrutiny or tracking to create more visibility to stakeholders
- Prior actions required relating to implementation of technical PFM improvements
- Prior actions required on legislation and regulations relating to financial management
- Earmarking of donor funding to identifiable expenditures
- Review of readiness (capability) of institutions to manage funding and introduction of peer and civil society pressure

Source: DFID, 2008a.

7.49 UK guidelines stress the importance of ensuring a smart use of short-term safeguards, taking into account (a) the ultimate objective of strengthening country systems in order to use them, and (b) that the donor group in a country may be considering the use of multiple safeguards. The UK guidance is reproduced in Box 7.5.

Box 7.5: Smart use of short-term safeguards

Short term safeguards need to be used intelligently, not in a simplistic 'problem-solution' way. Research indicates that short-term safeguards can be fragmented and ineffective in providing protection, particularly where numerous donors each impose their own requirements. In considering the appropriateness of short-term safeguards, care should be taken to avoid potential negative impacts on the PFMA system as a whole. The promotion of parallel systems may undermine long term systemic improvement, attract skilled staff away from essential government posts or create over-reliance on short-term external technical assistance. Short term safeguards should be designed with an exit strategy and a view to passing responsibility for their implementation to the partner government. …

To be effective safeguards need to be designed in a balanced and proportionate way – not only in themselves but in terms of how they fit into the overall picture. Careful attention needs to be paid to the interaction of short term safeguards (both DFID's and those of others) with the underlying national system and on-going medium to long term reform programmes.

Source: DFID, 2008a.

7.50 Other donors also highlight the potential costs involved in some individual safeguard measures. One example is earmarking. Most of the donors in the stocktake do not advocate the use of earmarking or other additionality conditions as a risk-mitigating strategy but it is recognised to be a possible short-term safeguard and both the EC and the World Bank will consider earmarking funds in countries with significant cash-flow and budget execution problems (EC) and where transition programmes have requirements for external financing to be channelled to support specific programs, such as demobilization, or exclude others (World Bank). However, both the EC and the World Bank guidelines stress that earmarking should be used sparingly because it constrains flexibility in the budget process and the establishment of additional fiduciary arrangements has significant cost and developmental implications.

7.51 Finally, no donor explicitly advocates the use of shorter-duration commitments as a safeguard. All donors see long-term commitments as important. This commonly means 3-year rolling commitments, although the EC is looking to implement "Millennium Development Goal (MDG) contracts" with 6-year commitments and DFID is increasingly entering into 10-year "Development Partnership Arrangements" with partner governments which include the aid framework for the current spending period.) Donors will consider the use of annual programmes in post-crisis, fragile states. For example the EC would look at the advantages of providing a single tranche annual payment based on agreement to a financial stabilisation and economic recovery plan. Such support would normally be the first step in preparing a medium-term programme of support. Sweden too details that there may be a need for short-term budget support in the case of new democracies, post-conflict countries or countries that have suffered a serious exogenous shock. In such situations, emergency needs and the strong impact funding is expected to have must be weighed against the risks of providing budget support when the conditions for it are not fully met

Sharing risk with other donors

7.52 Sharing risk with other donors is emphasised by most of the donors to be an important risk-mitigating strategy. This can involve working with other donors in a harmonised manner and it can involve working through other donors. Risk-sharing with partner donors is seen as particularly important in fragile states. The Netherlands describes this as "to preclude subjectivity and arbitrariness" in accepting risks (Ministry of Foreign Affairs, The Netherlands, 2005).

7.53 Donors' guidance on risk management includes good practice guidelines on harmonisation of donor approaches to risk management. Donors commonly stress the importance of collaborating, including on the following activities:

- assessments of risks
- the design of mitigating strategies (ensuring that donor strategies are complementary, especially in the case of short-term safeguards, as discussed in ¶7.49)
- the design of complementary capacity-building inputs (for support to reform programmes in PFM and in the fight against corruption. The donor guidelines on this have been summarised in ¶7.31–¶7.34)
- MOU and Codes of Conduct for budget support donor groups and the government
- dialogue (policy and political, with the government)
- monitoring (harmonising performance indicators on PRS-based PAFs and joint monitoring of PAFs)
- review (budget support and sector support donor groups tend to have joint Annual Reviews)
- response to breaches (see discussion in next section).

7.54 The EC sets out a list of principles for making "donor-donor coordination" work, which all have relevance for the design of donors' risk management strategies (see Box 7.6).

Box 7.6: Donor–donor coordination (EC principles)

Making donor–donor coordination work. For example: (i) sharing information, for instance by relying on common diagnostics (for example, in the area of PFM), or establishing a common website; (ii) promoting the effective division of labour between different development partners; (iii) avoiding complex discussions over common donor procurement procedures – for example for technical assistance; (iv) making use of the "operational coordination" with EU Member States to encourage greater harmonisation of approach between the Commission and Member States.

Source: EuropeAid, 2007.

7.55 In the event that joint financing is agreed, and all donors agree that it is advisable to coordinate closely the content, timing and approach of their development policy operations with each other (taken from World Bank guidelines), Joint Financing Arrangements (JFAs) aim to facilitate donor coordination of budget support. The JFA Guide includes guidance on the agreement of a common risk management and mitigation strategy, as shown in Box 7.7.

Box 7.7: JFA: common risk management and mitigation strategy

¶10. Added value of joint financing

When considering a JFA, partners under the arrangement should be clear on its purpose, its added value and the potential risks. **They should also decide on a common risk management and mitigation strategy**. Joint financing should produce added value over bilateral financing by individual donors in as much as it results in reduced transaction costs for management and monitoring, greater programme efficiencies for all parties involved and the avoidance of duplication of effort by donors and partner governments alike. T**he signatories to the JFA can benefit from jointly determined objectives and results, more focused dialogue and the prevention of 'island approaches' to development, as well as from the synergy of pooling resources.**

Source: Nordic Plus, 2007 [bold added].

Key Commonalities	Most of the donors look to share risk with other donors as part of their risk management strategy. All seek to harmonise with other donors on complementary capacity-building measures, monitoring indicators and other operational elements.
Key Differences	Some donors emphasise sharing risk as a mitigating strategy more than others.
Opportunity	Scope for more sharing of risk analysis. (As with PEFA, factual analysis can be shared even if different decision criteria are applied) Scope for increased sharing of risk, and for collaboration in risk mitigation efforts. Scope for continuing collaboration on established harmonisation tools, including JFAs and PAFs.

8. Response to Breaches / 'Crises'

8.1 Every donor retains the right to reduce, suspend or terminate payments of its aid programme in the event of:

- serious under-performance against agreed disbursement conditions
- breach of the fundamental conditions of the partnership (see ¶7.42).

8.2 The two categories of breaches are very different, and within the categories there will be multiple types of breaches and complex causes. Under-performance against agreed disbursement conditions could be the result of a number of factors. Breaches of fundamental conditions could be a slow deterioration of the partnership between donor and government or it could be a sudden crisis. Corruption and human rights crises can make donors' decisions on whether to continue to give aid (and budget support in particular) headline news, putting donors' reputations at risk and requiring them to call upon delicate crisis management skills. Each type of hazard (the realisation of risk) requires an appropriate response.

8.3 Risks are addressed at the operational level in the design, and then the monitoring of individual interventions. When breaches occur, they may be dealt with at operational level, but if serious may have programme and strategic implications.

Contingency planning

8.4 Some of the donors in the stocktake set out good practice of contingency planning to deal with such eventualities. Part of contingency planning is having a a well thought-out communication strategy to mitigate risks, and, especially, reputational risks. The importance of this is stressed by the UK, the EC and the World Bank in particular. For example, the World Bank lists among the key mitigating measures:

> Include a communications strategy in program design if there is a significant risk that political support for program implementation might be jeopardised by public misunderstanding of its intent or impacts. … Integrate strategic communications interventions to address risks that might arise from political, social, and cultural dynamics related to the operation. (World Bank, 2005)

Policy of appropriate responses

8.5 Setting out the policy of appropriate responses and procedures in the event of breaches of the partnership agreements is emphasised by some of the donors to be good practice because it ensures the donors' behaviour is clear, transparent and (if abided by) as predictable as possible (to all stakeholders: government, other donors, civil society – and to the donor domestic constituency).

8.6 Donors commonly have a standard clause in the MOU with the government which gives the donor the right to modify or terminate the financial contribution if consultations between the parties do not resolve the matter. The Netherlands also sets up a special "corruption clause" (fighting corruption has been a priority within Dutch cooperation policy for some time), supplementary to the termination clause in contracts and MOUs/General Arrangements, which sets out the conditions under which the Ministry can withhold payments, void the contract or start an investigation.

8.7 For all donors, decisions on responses to serious breaches will ultimately be taken by the highest responsible officer, which for bilaterals will commonly be the Minister.

8.8 Among the donors reviewed for this stocktake that have available policies on the response to breaches (the Netherlands, Sweden, the UK, the EC and the World Bank), the response policies and procedures of the bilateral donors and the EC are similar. All agree that each sanction should be in reasonable proportion to the gravity of the non-performance. They do not have pre-set responses for particular cases, all emphasising that situations should be judged on a case-by-case basis. Some donors stress the need for a graduated response, which for some (in particular the EC) is achieved through linking disbursement of budget support to variable tranches (see discussion at ¶7.46). The UK policy is generally not to use benchmarks as part of a formal process of graduated response (making decisions instead on a case-by-case basis).

8.9 The Netherlands have a clear policy of zero tolerance in the case of corruption or malpractice. The Netherlands stands out as having a clear, transparent list of the sanctions possible in the case of a breach of partnership when giving budget support. This is shown in Table 8.1. The Netherlands policy specifies that the sanctions imposed largely depend on the circumstances in the country concerned and that the sanctions must be proportionate and gradual, to avoid a stop-and-go policy.

Table 8.1: The Netherlands' policy on sanctions in the case of budget support

In the case of budget support, the following sanctions are available:

- a freeze on new commitments: no budget support is provided for a subsequent period;
- reduction of committed budget support: less is paid than originally agreed;
- suspension of payments: no more of the committed budget support is paid until demonstrable improvements have been made;
- reduction or cessation of budget support may be accompanied by the disbursement of funds through a different aid modality;
- calling into question the long-term relationship between the Minister and the recipient country: this is a very harsh measure that is only used if governance has deteriorated significantly, the democratic process has broken down, there are serious violations of human rights, the recipient country shows a complete lack of political will to carry out reforms, or international obligations are being breached, e.g. regarding peace and security. In such cases, it is not merely budget support but the entire development relationship with the country concerned that is reconsidered. This is always a political decision by the Minister for Development Cooperation.

Source: DEK and FEX, 2006.

8.10 The UK emphasises the need to formulate an alternative plan that minimizes any adverse impacts on the intended beneficiaries of the aid programme, and includes in its range of responses the options of: 1) changing the way DFID delivers aid to government or 2) switching some or all of DFID's aid away from government to non-government channels.

8.11 As noted (¶7.29) some donors regard sector budget support as less vulnerable to interruption when there is a political crisis. Thus the design of different aid modalities that use country systems is a factor in limiting the risk of interruptions due to political crises.

8.12 In contrast to the other donors, the World Bank has detailed guidelines for determining response to particular non-compliance. The response is linked to the financial management process (for example, in the case of failure to deliver audited financial statements within four months the Bank reserves the right to "reject withdrawal applications supported by interim reports or summary statements of expenditures, and/or withhold making further advances of the loan"). At the same time, many of the World Bank responses involve consultation and a series of graduated responses; thus, in practice, the World Bank also exercises discretion. The World Bank's mandate does not allow it to suspend aid on purely political grounds.

Policy of appropriate procedures

8.13 All donors set out the procedures that donors should follow in the event of a breach of conditions. For all donors, the first response to underperformance or a suspected breach of partnership centres on dialogue with the government and other donors, and looking to reach agreement on an action plan. Generally donors' procedures include the following good practice:

- First action is to consult with the government in a timely manner (the EC Cotonou Agreement in particular sets out detailed consultation procedures in the case of perceived failure to fulfil an obligation stemming from human rights, democratic principles and the rule of law (Article 96) and in the case of perceived corruption (Article 97))
- Harmonise with other donors (the UK includes for human rights issues that DFID should coordinate with multilateral organisations of which DFID is a member, such as the EC and the UN, which may have a comparative advantage in raising and discussing concerns).

8.14 Formal and informal coordination amongst donors in response to crises may be seen both as a way of minimising unpredictability and as a way of sending stronger signals to the government. Some MOUs (e.g. the agreement among the Programme Aid Partners in Mozambique), require consultation with the budget support group before any individual donor suspends budget support.

Transparency

8.15 Not all donors have developed policies to guide their response to breaches in partnership between the donor and the government partner, or at least not ones that are publicly available. In addition most donors do not publish regular reports of their experiences of breaches.[22]

Opportunity	Increased transparency of policies and procedures for responses to breaches and crises, more sharing of experiences, and reflection on the lessons these may hold for design of aid modalities as well as for damage-limitation in the management of crises.

[22] DFID is an exception as it publishes an overview of breaches and the reasons for their occurrence in its annual report.

9. Issues and Next Steps

9.1 Throughout the report, observations, generally in the form of commonalities and differences, have been highlighted and these have informed ‘opportunities’ for donors to increase harmonisation and coordination of efforts as a step towards the greater use of country systems. In this final short chapter we summarise what seem to be the most important issues and opportunities that the JV PFM, and individual donors, may wish to follow up.

9.2 The stocktake reveals a surge in the number and the breadth of various assessments being undertaken by donors in connection with efforts to follow up the Paris Declaration commitments to greater use of country systems. This picture revealed by this stocktake suggests some potential concerns, as follows:

(a) A concern that the configuration of risks and benefits associated with using country systems is such that donors are likely to experience a built-in bias against the use of country systems in practice. Decisions at operational level are likely to be more risk-averse than the strategic policy guidance of donor headquarters would suggest.

(b) Another concern is with the potential for high transactions costs and inefficiency in the number of different, and often uncoordinated, assessments now being undertaken. There is also a risk of bypassing country stakeholders in the conduct of such assessments.

(c) A third main concern is that the safeguards and other mitigating strategies adopted in conjunction with the greater use of country systems may undermine the benefits derived from using country systems.

9.3 However, for all of these concerns there are corresponding opportunities, both for individual donors and for donors working collaboratively. Thus:

(a) Donors can review the consistency in their policies and practices on addressing risk at different levels of the organisation and seek to rectify unintentional biases against the use of country systems.

(b) There is scope for collaboration on many of the reviews and assessments that donors require. The PEFA experience provides a pattern that shows it may be possible to agree on a transparent assessment that different users can feed into their separate decision-making processes. At various points we have observed that there may be scope for shared learning on terminology and assessment methodologies and assessment tools concerning fiduciary risks, corruption, and other aspects of governance. It is important to involve partner governments and other partner country stakeholders in these efforts.

(c) There is also scope for joint learning concerning the better design of aid instruments that use country systems, and in using different aid instruments (e.g. general and sector budget support) in ways that reduce and spread risks.

(d) There is scope for donors to collaborate also in the delivery of aid through country systems, in ways that reduce the risks that each donor faces and at the same time seek to combine forces in strengthening country systems (e.g. in supporting capacity building, and harmonising so as to avoid the multiplication of separate donor conditions and safeguards).

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