The Development Challenge in the Context of Financial Accountability

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INTRODUCTION

The ultimate benefit that the donor community seeks from the support it gives is poverty reduction, as measured by progress towards the Millennium Development Goals. There are also important intermediate benefits that have demonstrable links to poverty reduction, such as improvements in economic and political governance.

The increasing adoption of poverty reduction strategies presents an important opportunity to reform the relationship between donors and developing countries. Donor assistance should be provided in a way that builds, rather than undermines, recipients’ sustainable capacity to design and implement these strategies.

FINANCIAL ACCOUNTABILITY ISSUES AND CHALLENGES IN DEVELOPING COUNTRIES

Financial accountability is a basic building block for development. These basics are becoming increasingly important as the Organisation for Economic Co-operation and Development (OECD) countries focus on issues such as corruption, the use of resources in Highly-Indebted Poor Countries (HIPC), decentralisation and community use of donor resources, and service delivery. A policy document recently issued by the British Department for International Development (DFID) confirms the fact that development assistance is an inherently high-risk activity. Donors generally face fiduciary risk in client countries that do not publish timely annual financial statements, do not provide timely and independent audits, and do not allow for timely public and parliamentary review. The risk applies to both investment lending and adjustment lending activities. While the former funding activities focus on discrete projects and programmes of investment for the delivery of goods and services, the latter is designed to support the introduction of basic changes in economic, financial and other policies of key importance for economic development by providing development funds directly to recipient governments to be spent as part of their budgets (i.e. direct budget support).

In most of the poorest countries that donors support, public financial management and accountability systems fall well below internationally accepted standards of good practice. The countries that are in greatest need of assistance are necessarily those that are
most prone to natural disaster, external economic shocks, capacity constraints and political instability. While most of these countries have formal rules in their constitution, organic finance laws and regulations designed to ensure financial accountability, the donor community currently lends to many countries that do not implement reliable internal financial control systems nor foster fiduciary responsibility. In many cases government financial accountability has eroded, fostered by weak enforcement of laws and regulations.

These countries also tend to have incomplete and unreliable information on which to base assessments of both risks and benefits. Many of these risks are beyond the control of any donor or even the recipient country government. Although multilateral and bilateral donors generally put in place measures to help ensure that lent funds and grants are utilised for the purposes intended, in the end all financial resources are fungible, and fully transparent reporting, accounting, and auditing are not generally practised in recipient countries.

However, important elements of risk are controllable and the process of risk assessment and mitigation is critical to effective aid delivery. In such circumstances direct budget support may still offer the most effective means of delivering development assistance, provided that, inter alia, the following conditions are met:

- A thorough evaluation of public financial management and accountability systems, and associated risks, has been carried out.
- The potential developmental benefits justify the risks, taking account of any safeguards that can be put in place to buttress and develop these systems.
- The government has a credible programme to strengthen the effectiveness of government systems and there are good prospects that long-term financial planning by recipient governments would be enhanced.
- There is potential to strengthen local ownership and make the government more accountable to its people by allowing it to focus on the issue of poverty reduction.

EMPHASIS ON FINANCIAL ACCOUNTABILITY ASSESSMENTS

Many developing countries are now benefiting from the original and enhanced HIPC debt relief initiatives launched by the World Bank and International Monetary Fund (IMF) in 1998 and 2000 respectively. The executive boards of both Bretton Woods institutions have identified the capacity to track poverty-reducing spending as critical to the success of the enhanced HIPC. Consequently they have requested that the countries that benefited from the HIPC initiatives be assessed and a report be prepared with the objective of improving such capacity.

This initiative has helped to focus international attention on how governments are using and accounting for the resources freed up by the reduction in debt repayments and interest. Development agencies and governments have recognised that joint approaches to the assessment of public financial management systems, institutional strengthening and monitoring will reduce transaction costs, bringing benefits for all parties. There is general
agreement about the need for a more common and shared level of knowledge on the overall public financial management situation in developing countries, as well as a better picture of existing initiatives of improvements and technical assistance.

A study commissioned by the Norwegian Agency for Development Cooperation (NORAD) states that the mapping and analyses of a financial accountability system in a given country is inherently a complicated and wide-ranging task. The mapping would need to cover central and local institutions, the tax system and collection, activities and transactions of state-owned companies and extra-budgetary funds such as pension schemes — in short the entire public expenditure management system.

There are difficult questions of accounting definitions in areas such as privatisation returns, public debt and debt guarantees, etc. and the information is not readily available in many countries. However, the need to enhance these systems in developing countries, as well as the need to account for the large budget support and debt relief programmes to the public in the donor countries, requires the donors to make such assessments. International initiatives are now underway in the Development Assistance Committee (DAC) of the OECD and the Strategic Partnership with Africa (SPA) to harmonise approaches. Collaboration with other agencies, both in the field and at international level, is increasingly becoming an essential part of the work to improve aid effectiveness.

A key issue in a Country Financial Accountability Assessment (CFAA) is assessing the risk to donor funds. In developmental terms the risk is that these funds, as part of the budget and flowing through the country’s public financial management system, will not be well spent on poverty reduction. The key components of this risk are:

• The budget is not implemented as passed. Reasons for this might include unrealistic budgets and inadequate internal controls, including information flows, to allocate budget funds and to adhere to budget limits. Other factors could be budgets that are not “owned” by spending ministers or ministries and other reasons for lack of commitment to fiscal discipline.
• Significant parts of government activity are not covered by the budget. Given that money is fungible, the risk is that support to the budget will lead to other government funds being diverted to off-budget activities, and about which there may be little transparency.
• There is insufficient reliable information on budget execution. This may reflect inadequate internal control and accounting systems or lack of fiscal transparency generally.
• Diversion or waste of funds through corrupt practices. Official corruption, both grand and petty, may be a major risk to donor funds.
• There are gaps between formal Public Financial Management regulations or procedures and actual practices, because of institutional or governance factors (e.g. a technically sound internal control system is not enforced).

Changes in the international development aid business over the years — the growth of adjustment lending, debt relief and the growth of sector programs — have reduced the relative importance of tracking individual borrower transactions as a source of fiduciary assurance, and have increased the importance of assessing the country’s own public financial accountability systems. When funds are granted to the recipient government for

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1 Taken from Draft Revised CFAA Guidelines to Staff, World Bank, 2002.
direct budget support donors are not directly responsible for the use of those funds. Rather, they are responsible for making a sound ex-ante assessment of the effectiveness of the recipient government’s systems and practices, deciding whether the level of risk is acceptable, and taking appropriate steps to mitigate and monitor the risks.

**TYPES OF FINANCIAL ACCOUNTABILITY ASSESSMENTS**

It is important that the donor agencies have a sound understanding of the broader financial accountability environment within which its funds are spent, be able to assess the risks that these arrangements may pose to these funds, and work to strengthen public financial management.

A financial accountability assessment should be undertaken to review the mechanics of the government public expenditure management system. The review should also assess the broader accountability framework, including the effectiveness of independent scrutiny of the executive by the legislature, external audit and civil society organisations. Such a financial accountability assessment should be used to establish a baseline, supplemented by additional baseline information on objectives, against which government and development agencies can measure progress.

A number of mechanisms and initiatives exist for assessing the public financial accountability in developing countries. They are performed as a diagnosis of a country’s financial management systems for two main purposes, namely:

- **Fiduciary risk management**: To provide reasonable assurance to the borrower and the donors that proper checks and balances exist in the country’s financial accountability framework, as designed and as practised, for ensuring intended use of public funds (country’s own money as well as the money that donors provide to the country).
- **Development strategy**: To assist a client country in designing and implementing a strong financial accountability framework (in conformity with internationally recognised best practices) for supporting national financial stability and economic development, as well as for strengthening the international financial architecture.

The mechanisms include:

- **IMF – Reports on Observance of Standards and Codes (ROSCs) on Fiscal Transparency**: The important feature about the ROSC process is the fact that it focuses on fiscal transparency and not on the wider ranging issue of budget and accounting systems and outcomes. The ROSC is considered to be a suitable document for credit rating purposes, since it directs itself towards the question of what level of confidence one can have of the fiscal policy systems of individual countries.
- **IMF/World Bank – Financial management assessment linked to HIPC**: The joint World Bank/IMF financial management assessment under the HIPC process is a fairly new assessment mechanism. The focus of the exercise is to assess the possibility of tracking poverty-related spending in the public budget management systems of the HIPC countries.
• **World Bank – CFAA**: This is a diagnostic tool designed to enhance the Bank’s knowledge of public financial accountability arrangements in client countries. A key issue in a CFAA is assessing the risk to Bank funds. In developmental terms the risk is that Bank funds, as part of the budget and flowing through the country’s public financial management system, will not be well spent on poverty reduction.

• **World Bank – Country Procurement Assessment Report (CPAR)**: The CPAR is a useful tool to review public procurement institutions, policies and practices in borrower countries.

• **World Bank – Public Expenditure Review (PER)**: This tool analyses the country’s fiscal position, expenditure policies – in particular the extent to which they are pro-poor, and public expenditure management systems. Other issues may also be examined, for example institutional arrangements for public expenditure management, civil service reform, revenue policy and administration, etc.

• **Similar relevant assessments**: In a number of countries, the bilateral donors have cooperated to produce different types of assessment reports in the area of financial management. This has been linked to efforts to coordinate budget or balance-of-payment support programmes, and for specific sectors also in connection with sector programmes.

In future it is expected that much more of this diagnostic work will be carried out as an integrated exercise, as the World Bank, IMF and other donor agencies move to coordinate these diagnostics. Under the new Public Expenditure and Financial Accountability (PEFA) Program donors are working within the SPA and the DAC to promote joint fiduciary assessments by development agencies. This new programme is financed jointly by the World Bank, the European Commission (EC) and DFID, and it aims to develop a more integrated, strategic, comprehensive and collaborative approach to assessing and reforming countries’ public expenditure and financial accountability systems, and identification of performance indicators and benchmarks.

This integrated approach would merge some of the mechanisms listed above into a single fiduciary assessment process, which can be relied upon and participated in by recipient governments and development agencies. This work programme should cover all aspects of the public expenditure cycle (including economic analysis of public spending, expenditure incidence and poverty impact, governance and institutional environment, budget formulation, budget execution, public procurement and expenditure monitoring, reporting and auditing) and, where relevant, the revenue side of the budget. Governance and institutional issues should be addressed in addition to technical issues. All branches of government should be covered and, as far as possible, national and sub-national levels of government.
CLOSER TO AFRICA

The SPA partner countries in Africa are all poor and face substantial development challenges. The SPA countries are all dependent on capital inflows that are large in relation to the size of their economies and have an enormous backlog of developmental needs. The overall financial and fiscal situation is uncertain and changing because of the combined uncertainty of macroeconomic developments and the uncertainty of the inflow of either donor funds or private capital. This uncertainty is very difficult to handle for many of the SPA partner countries.

Improved public financial accountability systems are increasingly seen as crucial for the effectiveness of poverty reduction policies and programmes, and for the willingness of donors to provide development assistance through national systems in developing countries, and in particular for the willingness to provide broad budget support. Improved public financial management is therefore an issue of high priority within the New Partnership for Africa’s Development (NEPAD).

This partnership is a pledge by African leaders, based on a common vision and a firm and shared conviction, that they have a pressing duty to eradicate poverty and to place their countries, both individually and collectively, on a path of sustainable growth and development and, at the same time, to participate actively in the world economy and body politic. It aims to build confidence, accelerated sustainable development and reduce poverty in Africa — “a new compact between Africa’s leaders and its people”. As the NEPAD's programme becomes better defined, the modalities for donor support will become clearer.

CONCLUSION

Sound management of public financial resources is essential for an effective use of public resources towards the overall objective of poverty reduction. Therefore, sound financial management is essential for the effectiveness of budget support (both at the macro and sector level), debt relief, HIPC programmes and other support for national poverty reduction strategies channelled through national systems. As a consequence, there is an increasing focus on the soundness of financial management in developing countries. The increased concern of good governance and corruption adds to this emphasis on sound financial management. These countries can and should play a role in improving financial management.

In addition, co-ordination of donor efforts is a key issue to carry the development efforts forward, since there is need for collaboration between bilateral donors, the IMF, the World Bank and the UN system. It is important to recognise that improvements in financial management are a long-term process.

2 For more information on the New Partnership for Africa's Development, go to:  http://www.nepad.org