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(Information)

COURT OF AUDITORS

SPECIAL REPORT No 2/2005

concerning EDF budget aid to ACP countries: the Commission's management of the public finance reform aspect, together with the Commission's replies

(presented pursuant to Article 248(4) second subparagraph of the EC Treaty)

(2005/C 249/01)

CONTENTS

ABBREVIATIONS AND TERMINOLOGY

ACP	—	African, Caribbean and Pacific States signatory to the Cotonou Agreement
ADB	—	African Development Bank
AFD	—	French Development Agency
BWIs	—	Bretton Woods Institutions (WB and IMF)
CFAA	—	Country Financial Accountability Assessment
CPAR	—	Country Procurement Analytical Review
DFID	—	UK Department for International Development
EDF	—	European Development Fund
EMCP	—	Expenditure Management and Control Programme
FRA	—	Fiduciary Risk Assessment
GBOFT	—	Government budgetary operations and financing table
HIPC	—	Highly indebted poor country
HOAP	—	Harmonisation of overseas audit practice
IFAC	—	International Federation of Accountants
IMF	—	International Monetary Fund
ISA	—	International Standards on Auditing
MoU	—	Memorandum of Understanding
NIP	—	National Indicative Programme
OECD	—	Organisation for Economic Cooperation and Development
PAF	—	Performance Assessment Framework
PARPA	—	*Plano de Acção para a Redução da Pobreza Absoluta* (action plan to reduce absolute poverty)
PEFA	—	Public expenditure financial accountability
PEMFA	—	Public expenditure management and financial accountability
PER	—	Public expenditure review
PETS	—	Public expenditure tracking survey
PF	—	Public finances
PFMA	—	Public finance management assessment
PPARP	—	Multiannual support programme for poverty reduction
PRGF	—	Poverty reduction and growth facility
PRSP	—	Poverty reduction strategy paper
PSCAP	—	Public service capacity building programme
ROSC	—	Report on the observance of standards and codes
SAI	—	Supreme audit institution
SISTAFE	—	*Sistema de Administração Financeira do Estado* (government financial administration system)
WB	—	World Bank

SUMMARY

Description of the mechanism

I. The volume of direct non-targeted budget aid has increased substantially in recent years and now accounts for around one fifth of EDF aid. It has several major advantages, chief of which are ownership and greater simplicity (see paragraphs 9 to 11), but it also brings an element of risk. This risk differs from that affecting other types of aid (see paragraphs 12 and 13): the objectives are more ambitious and the funds disbursed are merged with the revenue of the beneficiary countries, which then spend them in accordance with their own management systems, which are usually weak. The philosophy behind budget aid is to help beneficiary countries to reduce this risk while at the same time allowing them to manage their own development through growth and poverty reduction. Most donors are showing an increased interest in this form of aid, which is fundamentally different from the traditional method of project support (see paragraph 11).

II. The Commission is prepared to transfer budget aid to countries with weak management systems, provided that reforms are put in place to improve them (see paragraphs 28 and 29). This is a long-term process. It has therefore developed tools with the aim not only of making an initial diagnosis of the quality of the public finance management and proposed reforms, but also of evaluating management changes and the progress of those reforms.

The Court's audit

III. The objective of this audit was to examine, for 2003 and 2004, how the Commission had managed the risk linked to public finance within the framework of budget aid (see paragraph 12), i.e. how it had verified the quality of public finance management and the effectiveness of the reforms introduced by the beneficiary State (see paragraphs 19 and 20). The audit focused in particular on the programmes of direct non-targeted budget aid granted from the EDF within the framework of the Cotonou Agreement. It was based on checks performed at Commission headquarters and in five countries (see paragraphs 21 and 22).

Audit results

IV. The analytical and follow-up tools, which the Commission applies in coordination with the other donors, and the World Bank and IMF in particular, provide relatively comprehensive information that enables it to take appropriate action. However, the design (see paragraphs 23 to 27 and 42 to 46) and implementation (see paragraphs 31 to 37 and 47 to 68) of these tools need to be improved. There are some design weaknesses at the diagnostic level and in the monitoring reports, which are not sufficiently complete and informative. Furthermore, there is insufficient coordination with other donors at local level as regards the use of these instruments and their implementation does not rely sufficiently on the parliaments and supreme audit institutions of the beneficiary countries concerned.

V. The Court recommends that the Commission:

(a) update and complete its Methodological Guide, including the parts relating to monitoring reports (see paragraph 84);

(b) give clearer evidence for the eligibility of beneficiary countries (see paragraph 85);

(c) employ enhanced-incentive public finance performance indicators (see paragraph 86);

(d) finalise the new public finance management performance measurement tool and do its utmost to have it adopted by the various donors (see paragraph 87);

(e) strengthen local cooperation between donors (see paragraph 88);

(f) strengthen its relations with the parliaments and supreme audit institutions of beneficiary countries (see paragraph 89).

INTRODUCTION

1. In 2000, the Court examined the Commission's follow-up of the use of counterpart funds from structural adjustment support earmarked for budget aid in the ACP countries ([1]). The Commission has since replaced this form of assistance by budget aid, which now represents more than one quarter of total aid under the ninth EDF (see *table A* in *Annex 1*).

2. The Parliament ([2]) and the Council ([3]) have recognised the advantages of budget aid. They are concerned about the control arrangements for it and have urged the Commission to be vigilant in its observance of Article 61(2) of the Cotonou Agreement (see paragraph 18) and, in coordination with the other donors, to carry out more thorough appraisal of the direction taken by public finance management in the beneficiary countries as well as monitoring the progress of the reforms that are intended to improve it.

AUDIT FIELD: DIRECT NON-TARGETED BUDGET AID

Definition

3. Budget aid is paid into the budgets of beneficiary States to compensate for shortages in their domestic resources. It provides *de facto* support for their balance of payments and public finances. At present, most of the budget aid disbursed by the Commission is 'direct' and 'non-targeted'. The importance of this aid relative to total EDF assistance is shown in *table B* in *Annex 1*. The amount of budget aid by country is shown in *table C* in *Annex 1*.

4. The aid is 'direct' in that it enters budgets directly without the need for a counterpart allocation of currency for countries' essential imports. In general, this mechanism is no longer necessary because the currency of the beneficiary countries is nearly always convertible and freely transferable.

5. The aid is 'non-targeted' in that it is merged indistinguishably with other budgetary revenue and cannot be associated with specific expenditure, in contrast to targeted budget aid, where the EDF funds are paid into special accounts whose use requires the signature of the Heads of Delegation. Targeted budget aid is limited ([4]) to cases of countries experiencing serious liquidity problems.

Improving public finance management: one of the objectives of budget aid

6. The main objectives of budget aid are to facilitate growth and reduce poverty, both of which are among the United Nations' Millennium Development Goals ([5]).

7. For most of the ACP States concerned, this translates into a poverty reduction strategy paper (PRSP), which is drawn up by the country and approved by the main donors. This document sets out the principal medium-term guidelines adopted by the country to reduce poverty among its population.

8. Public finance management reforms are one element of the EDF's overall poverty reduction strategy and direct non-targeted budget support. Given the Commission's dynamic approach (see paragraph 28), such reforms become an important budget aid objective in themselves.

Advantages: ownership and greater simplicity for beneficiary countries

9. Direct non-targeted budget aid enables the Commission to enter fully into the issue of how national budgets are managed, by initiating permanent dialogue with countries on reforms to improve that management. European taxpayer's money has a leverage effect which helps to improve the overall quality and effectiveness of national budgetary revenue and expenditure. These improvements are beneficial to development as a whole and enhance the aid that is provided to donor-funded projects in all their forms.

10. Budget aid should provide countries with a better sense of ownership than aid supplied to a variety of projects. Moreover, the aid becomes an integral part of the budget and is thus subject to national parliamentary control.

11. Budget aid can greatly simplify the expenditure process by reducing the number of steps. Because it is merged with national budgets, it is spent according to national budgetary implementation procedures, whereas projects, which offer other advantages, are usually implemented outside beneficiary countries' budgets ([6]) and managed in accordance with the various donors' own procedures ([7]) (see *diagram 1*).

([1]) See Special Report No 5/2001 of the Court of Auditors (OJ C 257, 14.9.2001).

([2]) See the Resolution of the European Parliament containing the comments accompanying the decision concerning discharge to the Commission in respect of the implementation of the budget of the sixth, seventh and eighth EDFs for the 2002 financial year (OJ L 330, 4.11.2004).

([3]) See the Council's ACP/FIN Working Party document No 6107/04 of 19 February 2004 on the discharge to be given to the Commission in respect of the financial management of the sixth, seventh and eighth EDFs (financial year 2002).

([4]) In 2000, the Commission recognised that targeting was of limited effectiveness, owing largely to its side effects (delays in implementation and fragmentation of the budgetary process), the clumsiness of targeting procedures and, above all, the fungibility of the budget.

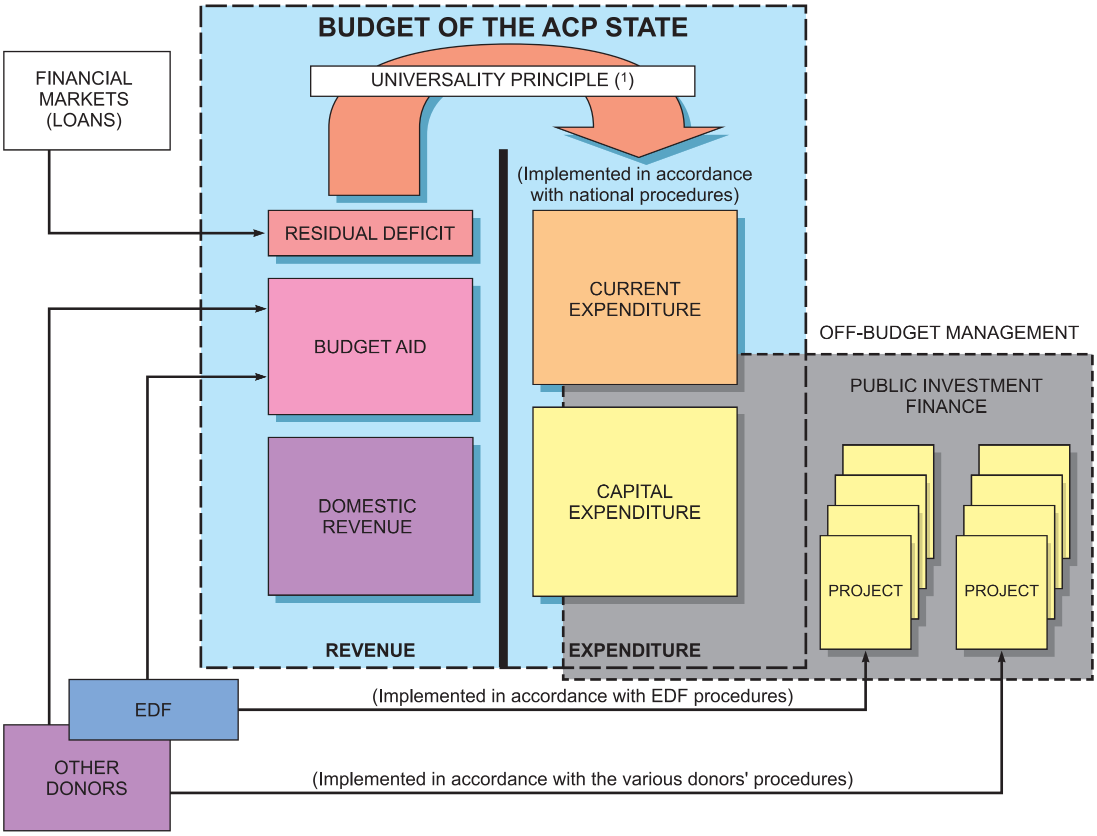
([5]) See Resolution No 55/2 adopted by the United Nations General Assembly on 8 September 2000.

([6]) This practice inhibits budgetary comprehensiveness. However, some projects, although managed outside the budget, are recorded in the annual accounts, thus resolving the problem of disclosure.

([7]) The practice of separate management often deprives government departments of qualified staff, who are employed to run these projects at ad hoc management centres offering higher rates of pay.

Diagram 1

The EDF aid circuit to budget support and projects



(1) According to the universality principle, in a public budget all revenue is available for all expenditure, instead of revenue being assigned to a specific category of expenditure.

Source: Court of Auditors.

Disadvantage: risks associated with the weakness of national public finance systems

12. Once direct non-targeted budget aid has been paid to the beneficiary countries, its use is subject to their national budgetary procedures. This exposes European taxpayers' money to the usually high risks affecting those procedures. Donors are conscious of these risks and accept them as long as reforms to improve the national budgetary procedures have been put in place.

13. Public finance reform is a lengthy process. By agreeing to channel aid over a period of years into developing systems that do not immediately provide sufficient guarantees in terms of transparency, reliability or effectiveness, donors are investing in the future.

14. A further consideration is that these budgets' dependence on external aid in general, including EDF aid (see *table D* in *Annex 1*), affects budget predictability and revenue reliability in the beneficiary countries. In some cases the problem is aggravated by the system of conditional variable tranches.

Implementation: aid is conditional

15. The Commission implements its direct non-targeted budget aid under three-year programmes. Funds are disbursed in half-yearly or annual tranches once the Commission has assessed the compliance with general preconditions (affecting the programme as a whole) and specific preconditions (relevant to a single tranche). Some tranches are variable, meaning that they are calculated on the basis of performance indicators.

Regulatory provisions

16. Article 67(1), (3) and (4) of the ACP/EC Partnership Agreement signed in Cotonou on 23 June 2000 (the Cotonou Agreement), which governs the ninth EDF, provides that ACP States wishing to benefit from budget aid must undertake macroeconomic or sectoral reforms that are economically viable and socially and politically bearable. In practice, where these reforms are supported by a Bretton Woods Institutions (BWI) programme, this condition is automatically satisfied.

17. According to Article 61(1)(c) of the Cotonou Agreement, aid is paid directly to ACP States with convertible and freely transferable currencies.

18. According to Article 61(2) of the Agreement, 'Direct budgetary assistance in support of macroeconomic or sectoral reforms shall be granted where:

(a) public expenditure management is sufficiently transparent, accountable and effective;

(b) well-defined macroeconomic or sectoral policies established by the country itself and agreed to by its main donors are in place; and

(c) public procurement is open and transparent'.

THE COURT'S AUDIT

Audit objective

19. The objective of this audit was to examine for 2003 and 2004 how the Commission had managed the risk linked to public finance and inherent to this type of aid, i.e. how it had verified the quality of public finance management and the effectiveness of the reforms introduced by the beneficiary State. This meant evaluating whether, both when the programme financing decision was taken and since the start of implementation:

(a) the Commission had defined a suitable *methodological framework* to allow it to assess the initial situation and subsequent development of the beneficiary countries' public finance management;

(b) this methodological framework was *implemented* correctly at both the initial and follow-up stages;

(c) the information on which the financing decisions were based, and, subsequently, the information in the follow-up documents, *gave a true view of the situation*; and

(d) the financing *decisions* were properly argued and transparent and the Commission had taken appropriate *action* as a consequence.

20. However, the audit did not set out to determine the advisability of using budget aid in preference to funding for projects, nor did it seek to assess the impact of budget aid on poverty reduction. Lastly, the objective did not include auditing public finance management and reform in the beneficiary countries even though, following analysis of documents, cross-checked with interviews and on-the-spot visits, the Court produced some findings concerning the public finance situation and the progress of reforms in those countries (see paragraphs 69 to 71).

Audit approach

21. Checks were carried out at Commission headquarters, and information was gathered from the World Bank and the International Monetary Fund (IMF). In the course of its audit visits in the five ACP countries visited (see *table 1*), the Court examined ongoing direct non-targeted budget aid programmes [1]. These countries were selected because they offer a variety of public finance management traditions and are representative (both geographically and in terms of value) of the budget support financed by the Commission.

[1] The main information gathered during the on-the-spot visits was corroborated by an Interministerial Conference on the public finance implications of results-based management, the medium-term expenditure framework and budget support, which was jointly organised by the Senegalese Ministry of Economy and Finance and IDEA International, in partnership with the Economy and Finance Ministries of Benin, Burkina Faso, Cape Verde and Mali and the development partners (WB, IMF, EU, Canada and the Netherlands). Auditors from the Court also attended.

Table 1

Programmes examined in the five countries visited

Country visited	Financing agreement examined and duration	Value (million euro)	As percentage of total aid planned under the 9th EDF
Ethiopia	No 9171/ET, 2003/2004 — 2005/2006 (1)	95	17,5 %
Mozambique	No 6567/MOZ, 2002 — 2005	168 (2)	51,7 %
Niger	No 9012/NIR, 2003 — 2005	90	26,0 %
Chad	No 9067/CD, 2004 — 2006	50	18,3 %
Zambia	No 9114/ZA, 2004 — 2006	117	33,3 %

(1) Ethiopia's budget year begins in July.
(2) A protocol assigned a further 16,4 million euro to Mozambique, as funding for the elections held in 2004.
Source: Financing agreements and National Indicative Programmes (NIPs) under the 9th EDF.

22. In each country visited, the first step was to review the agreements and reports that the Delegation had prepared. These were cross-checked against the reports by the other donors and the government and compared with the situation in the main departments active at the various levels of public finance management: budget programming and implementation, rendering of the accounts, internal and external audit (1).

AUDIT FINDINGS

Assessment of the initial public finance management situation

Definition of methodological framework

Methodological framework improved, but should be expanded

23. In March 2002 the EuropeAid Cooperation Office (EuropeAid), the Directorate-General for Development (DEV) and the External Relations Directorate-General (RELEX) established a 'Methodological Guide to the programming and implementation of budget support for third countries' (the Guide). This was in part a response to the Court's previous recommendations (2). The Guide remains, in 2005, the main reference document in this area. It is a significant improvement over the previous situation. However, examination showed it to be inadequate for the initial assessment of public finances.

24. The Guide does not place sufficient emphasis on domestic revenue, including revenue from public undertakings, which must be given the same consideration (3) as expenditure. This is, in fact, because improvements to domestic revenue collection and recovery, which may prove less costly and swifter to take effect than the reduction of irregular expenditure, reduce the external aid requirements to an equivalent extent and should provide taxpayers with more incentive to require the national authorities to account for their use.

25. The framework financing proposal over-summarises the list of information to be included in the public finance assessment. The Guide should provide a detailed template for this assessment, on the basis perhaps of that used for the Delegations' monitoring reports (see paragraph 42).

26. The section of the framework financing proposal that addresses the beneficiary country's eligibility omits all reference to Article 61(2) of the Cotonou Agreement (see paragraph 18).

(1) In each country, meetings were held with the parliamentary finance committee, various departments of the Ministry of Finance, two spending ministries, usually health and education (from central departments to outlying units such as schools or local health centres), internal and external audit bodies and the Central Bank, as well as representatives of the main donors, civil society and, where present, anticorruption NGOs.

(2) See Special Report No 5/2001 of the Court of Auditors on counterpart funds from structural adjustment support earmarked for budget aid (OJ C 257, 14.9.2001) and Special Report No 1/2002 concerning macrofinancial assistance (MFA) to third countries and structural adjustment facilities (SAF) in the Mediterranean countries (OJ C 121, 23.5.2002).

(3) While revenue is often taken into account in government reforms (see paragraph 70), the Commission must incorporate this aspect into its programmes more systematically.

27. Since March 2002, when the Guide was published, around 10 instruction notes have been addressed to the Delegations by a variety of Commission departments. As a result, there is no complete set of instructions for the implementation of budget aid measures. The guide is currently being updated. It would be beneficial if it could be completed as soon as possible, with provision for subsequent updates to be consolidated at regular intervals (1).

Dynamic interpretation of eligibility conditions

28. The Commission interprets the conditions set by Article 61(2) of the Cotonou Agreement in a dynamic manner. In its view, the weaknesses affecting public finance management at the time of the financing decision do not preclude the launch of a budget aid programme, provided that the will for reform exists and the reforms are deemed to be satisfactory. In this way it takes account not only of the initial situation of public finance management systems, but also of the direction being taken by the country (2). Many other donors, including the Bretton Woods institutions, similarly take account of the prospect of improving public finance management systems, rather than merely referring to a threshold value or an absolute qualitative level.

29. This interpretation extends the scope of this particular provision and thus increases the risk to which European taxpayers' money is exposed, because it is the beneficiary countries' national budgetary procedures that are being used. Such an interpretation requires much more rigorous monitoring of the situation and subsequent development of public finance management in the countries in question.

Cohesion between programmes should be made more explicit

30. Direct budget aid programmes do not focus sufficiently on the direction being taken by a country and the provision for follow-up. The Guide does not stipulate that all financing proposals and agreements must guarantee and make explicit the cohesion and logical relationship between the following:

(a) the weaknesses detected in the management of public finances;

(b) the government's programme of reforms;

(c) the institutional resources required to implement those reforms;

(d) the general and specific conditions (which govern programme implementation), performance indicators (which are used in the calculation of variable tranches) and other follow-up tools (which are considered in the dialogue with the national authorities, especially when the EDF programmes are due to be renewed).

(1) In the meantime, the Commission should put all the instructions needed for operational management of budget aid on its Intranet site, where they would be accessible to Commission staff.

(2) Section 3.4 of the Guide says, 'it is important to ensure both beforehand and in the course of implementing any support, that the direction on public finances taken by the country concerned may be deemed to be satisfactory'.

Implementation of the methodological framework

Initial assessments generally comprehensive and linked to the national reform programme

31. On the whole, the initial assessments of public finance management are reasonably comprehensive (3). The assessments make use of analyses and evaluations produced with the other donors, principally the Bretton Woods Institutions (BWIs), and the national authorities (see *Annex 2* and paragraphs 43 and 44) in order to report on the essential weaknesses affecting public finance. They usually summarise the prospects for improvement by reference to the national programme of reforms (4) (see *Box 1*).

Box 1 — Reference to beneficiaries' national reform plans

1. The assessment for Ethiopia analyses the prospects for improvement and refers to the measures planned in the Expenditure Management and Control Programme (EMCP) (1).

2. The Mozambique public finance assessment reports on the various reforms initiated by the government, the main one being the government financial management system SISTAFE (Sistema de Administração Financeira do Estado) (2), which was adopted at the end of 2002.

(3) The exception, however, is the initial assessment on Chad. Already sparse at the proposal stage, it no longer exists in the financing agreement, which includes only a few scattered scraps of information from it.

(4) From section 3.4(a), of the Guide: 'the assessment of how well public expenditure is managed must […] analyse any programme prepared by the government of the country concerned for improving the management of its public finances (including possible matrices for corrective measures) and the role played by the donor community. Such a programme should detail the action plan for implementing the reforms, which will be the subject of specific monitoring by the Commission'.

3. In Niger, as a response to the audit of the structural adjustment programme by the Commission in 2001 and the suspension of budget aid that followed it, the government and the Commission introduced a matrix for measuring improvement in public finance management. This was duly taken into account in the initial assessment.

4. The Chad financing proposal does not contain any analysis of the overall plan for public finance reforms, as it was not under development at the time.

5. The assessment for Zambia refers to the national reform programme, the 'Public Expenditure Management and Financial Accountability (PEMFA) Action Plan' (3), which was only available in draft form at the time when the initial assessment was drawn up.

(1) Footnote does not concern English version.

(2) Government financial management system.

(3) Footnote does not concern English version.

32. While, generally speaking, the bulk of information is given in the financing proposals and agreements, it is still too dispersed. The financing proposals and agreements do not set out systematically enough the arguments leading to the conclusion that, despite the weaknesses disclosed by the initial assessment of public finance management, the clause on the quality of public finances has been complied with (see paragraph 39). The presentation should be more standardised and structured in order to enable the EDF Committee [1] and the Commission to obtain assurance, during the process leading up to financing decisions, that any significant weaknesses have been taken into consideration.

33. The governments' reform programmes do not systematically include all the reforms, whether already launched, planned or awaiting consideration, that are necessary for the establishment of a sufficiently transparent, accountable and effective system of public finance management. In the dialogue with the national authorities the Commission should ensure that a comprehensive reform programme is drawn up, that it sets out priorities and is accompanied by a realistic timetable that is regularly revised. This medium and long-term perspective is especially important in a context where the management turnover rate at the Commission (both at headquarters and in the Delegations) and in the beneficiary countries outpaces the duration of the reforms.

(1) Consultative committee of representatives of the Member States.

Fighting corruption: an issue that needs to be developed

34. Another issue is that the Commission programmes do not adequately take account of problems related to corruption [2], which have been identified, by the World Bank in particular, as a major obstacle to poverty reduction. It is true that improving public finance management helps per se to reduce corruption. None the less, corruption merits specific attention. Although this topic is sensitive and not easy to broach, it is important, in partnership with the sovereign States and with the help of the organisations specialising in this field [3], to measure the extent of the phenomenon, which often appears under various headings, and to understand how it works so that the appropriate measures can be introduced and included by governments in their reform programmes.

Institutional support coordinated but not always part of an overall framework

35. The institutional support measures provided for in the financing agreements examined are well coordinated with the other donors, either explicitly in the agreements or, subsequently, during implementation. However, they are not always part of an overall institutional support programme [4] that identifies the finance provided by the various donors (see *box 2*).

Box 2 — Institutional support provided for in financing agreements

1. The financing agreement for Ethiopia provides that the 3,5 million euro earmarked for institutional support is to be paid into pooled donor funds. One of these is the public service capacity building programme PSCAP (1), a multi-donor overall support programme totalling USD 400 million over five years, piloted by the Ministry of Capacity Building (MCB).

2. In Mozambique the 5,5 million euro allocated for institutional support has been allocated to measures that are to be carried out jointly with the main donors. On the other hand, it has not been included in an overall support programme because there was none available when the financing proposal was drawn up.

(2) Article 9(3) of the Cotonou Agreement makes it clear that combating corruption is a key part of European Community development assistance.

(3) In December 2004, the OECD's Development Assistance Committee and Transparency International organised a Development Partnership Forum on the theme 'Improving donor effectiveness in combating corruption'.

(4) Section 1.3 of the Guide says, 'All institutional support must be provided as part of an overall support programme, drawn up by the government and supported by the donors, and must be complementary to any other funding provided by other donors'.

3. The programme in Niger earmarked 1,35 million euro for technical assistance measures for the Ministry of Economics and Finance. The planned measures are not part of an overall support programme.

4. In Chad 3,7 million euro has been set aside for capacity building. There are no precise details of the latter because the needs in that area had not been identified at the time when the financing proposal was drafted. Drafting of an overall support programme is expected towards the end of 2004, once the conclusions of the country financial accountability assessment (CFAA) [2] have been finalised.

5. In Zambia 6,75 million euro has been reserved for capacity building. It forms part of an overall support programme which had not been finalised at the time when the financing agreement was signed. The programme was signed by eleven donors in December 2004.

(1) Footnote does not concern English version.

(2) Footnote does not concern English version.

36. An overall support programme makes it possible to calculate the needs which can usefully be supported by the EDF. The Commission should ensure that a programme is drawn up, with an approximate timetable, to cover all necessary measures, including those for which finance has yet to be found.

No recommendations from the Heads of Delegation

37. The Heads of Delegation have not made recommendations as provided for in the Guide [1]. There are also plans to ask the Heads of Delegation to include, in their twice-yearly monitoring reports, an overall summary of their views, which is in part a consequence of the same approach. In both cases, it is of value to obtain formally the explicit views of persons who have ongoing close experience of the situation on the ground. The Commission should therefore retain this provision in the Guide and ensure that it is enforced.

(1) Section 3.4(i), of the Guide says, 'The Head of Delegation will write a recommendation on the quality of public finance management in that country and the prospects for improvement. […] AIDCO will then decide whether to draft a financing proposal'.

Information reflects the true picture

38. The Commission had identified all the public finance management weaknesses that the Court detected during its in-country audit visits. The exception was Chad, where there was found to be an arrears problem [2] of which the donors were apparently unaware.

Commission's decisions insufficiently argued

39. Having received a favourable opinion from the EDF Committee, the Commission decided to sign the five programmes examined, in spite of the public finance management weaknesses observed in the countries concerned, which indicates that it deemed the direction taken by the country to be satisfactory. More detailed reasons should be given for these conclusions, noting in particular how the reform programmes are expected to overcome those weaknesses (see paragraph 30).

40. Generally speaking, the initial situation regarding public finance management in the ACP countries is characterised by many weaknesses. In some of the countries visited, the Commission was one of the first donors to agree to accept this risk (see *box 3* and *tables E and F* in *Annex 1*). On each occasion, however, an IMF programme was concurrent.

Box 3 — Situation of other donors as regards non-targeted budget aid in the five countries visited

1. In Ethiopia the Commission was the first donor to grant non-targeted budget aid, in 2002. It was joined by the United Kingdom Department for International Development (DFID) [1], in 2003, and then by the World Bank and Ireland in 2004.

2. In Mozambique the number of donors granting budget aid has increased steadily since 2000, reaching around 15 in 2004.

(2) These arrears correspond to services rendered and billed (and therefore awaiting settlement) but contracted outside the scope of budgetary commitments and not included in the accounts. They are therefore not covered by the monitoring of arrears, which is carried out by the donors. It is not yet known precisely how much they are worth.

3. In Niger, in March 2004, the Commission, with the IMF, was the only donor which granted non-targeted budget aid. The World Bank and the ADB became involved at the end of 2004.

4. In Chad several donors in addition to the Commission have been providing budget support for a number of years. They include the African Development Bank (ADB), French Development Agency (Agence française de développement — AFD), World Bank and International Monetary Fund. However, the latter suspended renewal of its poverty reduction and growth facility (PRGF) and the Commission suspended its own programme.

5. In Zambia, in May 2004, the Commission, with the IMF and the World Bank, was the only donor providing budget aid. Some of the donors that the auditors met in the country welcomed the Commission's initiative and were prepared to participate in the overall capacity building programme, but were not disposed to provide budget support themselves in the immediate future.

(1) Footnote does not concern English version.

Monitoring the progress of reforms

Methodological framework under development

41. The main tools used to monitor the development of public finance management are the Delegations' monitoring reports and performance indicators.

Delegations' monitoring reports could be improved

42. The Guide specifies that the Delegations are to monitor public finances and report to the Commission central services [1]. The Delegations have been instructed that the half-yearly monitoring reports must contain a description of the situation (for which a pattern is given) and a framework for monitoring public finance reforms [2]. While the instructions are a valid management tool, the first indications arising from their implementation (see paragraphs 47 to 68) are that they could be improved and expanded by:

(a) bringing the template for describing the public finance situation into line with the measurement framework that is currently being developed by the Public Expenditure Financial Accountability (PEFA) partners [3] (see *Annex 2*);

(b) requiring systematic follow-up of the implementation of the institutional support programme so as to identify measures where difficulties or delays are being experienced;

(c) requiring an explicit assurance of consistency between the various analyses (the two referred to above and the framework for monitoring reforms);

(d) requiring the Delegation to give an overall opinion, accompanied by a recommendation for further action;

(e) requiring all the objective elements of these monitoring reports, as far as possible, to be drawn up jointly, or at least shared, with the other donors (each local representative office reporting to its respective headquarters, with, possibly, the ultimate aim of producing a joint document);

(f) requiring the national authorities to be involved as much as possible in the work of evaluation, with a view in particular to developing their audit capabilities. However, the quality of public finance management must be a matter of independent professional judgment;

(g) having the reports produced less frequently, on an annual basis, as the early warning procedure provided for in the Guide [4] makes action possible the same year.

(1) From section 5.3 of the Guide: 'the Delegation monitors the evolution of public finances through its relations with the local institutions (Ministry of Finance, Supreme Audit Institution, Central Bank, Public Accounts Committee of the National Parliament), other donors and civil society. It obtains from these institutions their regularly published reports and sends them to Headquarters with comments. The Delegation should pay particular attention to programmes of public finance reform and, where appropriate, to the implementation of measures agreed with donors and the European Commission (matrix of measures)'.

(2) The form and content of the half-yearly monitoring reports are specified in note no 24972 of 18 September 2003 from EuropeAid C3 to the Heads of Delegation.

(3) PEFA was set up in 2001 as a partnership between the World Bank, the European Commission, DFID, the Swiss State Secretariat for Economic Affairs, the French Ministry of Foreign Affairs, the Norwegian Ministry of Foreign Affairs and the IMF.

(4) The Guide specifies that the Heads of Delegation must initiate an early warning procedure if major problems arise which could impede the smooth running of the programme.

43. These reports rely on donor and government audits and evaluations, which are evolving in significant ways. In particular, the Commission is working with other donors, notably the World Bank, to develop a new public financial management performance measurement framework within the framework of PEFA (see *Annex 2*). This would take the place of the existing tools.

44. The Measurement Framework is currently being tested in around 30 countries (including 18 ACP States), in 14 of which the Commission has put itself forward as lead manager (1). As of 2005, therefore, the donors should have enough experience for them to be able to make the necessary improvements for the Framework to be adopted and made operational. Following examination of the Measurement Framework, some improvements have been proposed (see paragraph 7 of *Annex 2*).

Performance indicators are being improved

45. During the implementation of its budget aid programmes, the Commission uses performance indicators (see *Annex 3*) to measure progress in the quality of public finances and sectoral results, mainly with the aim of encouraging beneficiary countries to improve their public finance management. This it does by factoring the indicators into the calculation of variable tranches. The Guide provides much detail on the selection and use of performance indicators. In early 2005, the Commission launched an exercise on ways of improving them.

46. The performance indicators that are employed do not cover all aspects of the reforms being implemented because this would make them too numerous and unmanageable. It is therefore important to give reasons for the choices made and to indicate clearly which fields are not covered by the indicators, stating whether they are deemed to be low-priority, whether it was not possible to identify suitable indicators or whether the basic data required for the calculation of indicators are unreliable (in which case they could be made more secure in future).

Implementation of the methodological framework

Delegations' monitoring reports incomplete

47. All too often, the first monitoring reports (2) by the Delegations in the five countries visited are limited to a static analysis of public finance management. The analysis is usually of good quality and modelled on the template provided by headquarters. These reports are incomplete in that, among other things, the table on the monitoring of public finance reform is lacking (see *Box 4*). Better use should be made of them by the central services, which have not always responded by giving the Delegations clear instructions concerning the measures to be taken.

Box 4 — Monitoring reports in the five countries visited

1. In Ethiopia the two monitoring reports issued in March and July 2004 (2004-I and 2004-II) follow the template provided by headquarters and provide quality information, but the table on the monitoring of public finance reform has not been completed.

2. In Mozambique the first half-yearly monitoring report was delivered late, because of the limited human resources available in the Delegation. The report provides quality information and scrupulously follows the template, but lacks information on human resources management (section I.B.3 of the report), the retention of exceptional procedures for execution of expenditure (section II.B.4), and the recording of the most pressing needs in terms of capacity building (section III. C). The framework for monitoring public finance reforms is also missing.

3. The Delegation in Niger received instructions on the presentation of reports late and expected to compile its first monitoring report in the second half of 2004, after the PEMFAR (public expenditure management and financial accountability (1)) review had been finalised.

4. The delegation in Chad has sent two half-yearly monitoring reports, in April 2003 and in February 2004 (for the second half of 2003). The second one was late, due to human resources shortages in the Delegation. Headquarters commented briefly on the first report, with a list of the missing information. The second report scrupulously follows the template, but is incomplete, lacking information on the role of the parliament and institutional support provided by donors, as well as the framework for monitoring public finance reforms. Overall the information is precise and highlights persistent weaknesses clearly, although it does give rise to some questions about follow-up. For example:

(a) section I.B.3 of the monitoring report says that human resources are at the heart of the weaknesses in public finance management;

(b) section I.B.5 points out that there was also insufficient coordination between donors.

There is no indication of the action taken or to be taken in order to remedy these situations.

5. In the case of Zambia the financing agreement was signed in June 2004, so there had not yet been a monitoring report.

(1) Footnote does not concern English version.

(1) See note No 17450 of 9 June 2004 from the Directorate-General for Development and EuropeAid to the 14 Delegations concerned.

(2) The reports examined in the five countries were usually the first such to be published since the current programmes got underway.

Performance indicators sometimes offer too little incentive

48. The performance indicators are negotiated with the government (a cosignatory to the financing agreement), and are usually coordinated with the other donors. The nature and number of public finance management indicators, and consequently their suitability for encouraging the progress of reforms, vary enormously from one country to the next.

49. The indicators for budgetary allocation or implementation levels, which, when restricted to a single sector, more closely resemble sectoral input indicators, are relatively easy to measure but not the most effective way of encouraging ACP countries to improve management accountability, transparency and effectiveness. The indicators used in Ethiopia, Mozambique and Zambia are rather weak in this respect. On the other hand, the indicators in Niger and Chad ([1]) offer more incentive (see *Box 5*).

Box 5 — Public finance management performance indicators included in the financing agreements for the five countries visited

1. Ethiopia has three public finance indicators focusing on the financial timetable, progress of the Government Information System Strategy (GISS) ([1]), and the level of the budget allocation to the health and education sectors. They are, in fact, derived from the Poverty Reduction Strategy Paper (PRSP) ([2]) and are shared with the other donors.

2. Mozambique has eight public finance indicators, two of them focusing on budgetary discipline (their purpose is to verify that current expenditure does not exceed the amounts specified in the budget) and six on the level of implementation of current expenditure in the priority sectors. The indicators are not derived from the Plano de Acção para a Redução da Pobreza Absoluta (PARPA) ([3]) nor from the donors' common matrix, the PAF (performance assessment framework) ([4]).

3. Niger has seven public finance indicators focusing on: the recovery rate for the 'patente synthétique' (a source of revenue based on the informal sector. The recovery rate is considered to be abnormally low); rejection rate for commitment requests; time taken for payment instructions; level of arrears; clearance rate for delegated appropriations; implementation rate for transfer to Caisse Autonome du Fonds d'Entretien Routier (CAFER); allocation to CAFER funds. Some of these derive from the Programme Pluriannuel d'Appui à la Réduction de la Pauvreté (PPARP) and the others were agreed with the government as a result of shortcomings recorded during the audit of the structural adjustment programme in 2001. The other donors do not use indicators, but the appropriations are subject to special conditions.

4. Chad has 20 public finance indicators: six of them are prior conditions that function as indicators and focus on documents which the government must have presented or approved; seven relate to budget implementation rates (commitment/allocation or payments/commitments); one to arrears; two to procurement (contracting methods and time); two to progress in preparing calls for tenders and contracts; two to rates for delivery of major items of equipment to beneficiary structures. They are not derived from the PRSP (Poverty Reduction Strategy Paper), as only one of the 80 indicators which it proposes is relevant to public finance management.

5. Zambia has 12 public finance indicators. They focus on the drawing up of the budget (budget allocations consistent with established programmes and policies, with particular regard to the social sectors of education and health, Auditor General and poverty reduction programmes) and the actual implementation of the budget (funds are supplied in accordance with the budget allocation and linked to bank expenditure reconciliations).

([1]) Footnote does not concern English version.
([2]) Footnote does not concern English version.
([3]) Poverty reduction action plan.
([4]) Footnote does not concern English version.

50. On another matter, the financing agreements do not always give information of an adequate quality about indicators. Details explaining the grounds, definition, calculation method and sources of information for each indicator should be included systematically, as is the case of the financing agreement with Niger.

51. Subsequent to its exercise on 'conditionalities' in 2005, it would also be helpful if the Commission included pointers in the Guide as to the relative importance to be assigned to variable tranches and public finance performance indicators (see paragraphs 4 and 5 in *Annex 3*).

Unequal progress in different countries as regards coordination with other donors

52. The Guide rightly stresses the need to work, as far as possible, in coordination with other donors.

53. Donor coordination exists, firstly, at headquarters level and, secondly, between the donors' local representatives in each ACP country. There must in parallel be smooth lines of communication between these two levels within each donor organisation. At headquarters level, coordination on aspects relating to the monitoring of public finance performance is reasonably well organised in the form of the PEFA partnership (see paragraphs 42 and 43) ([2]), in which the Commission plays a leading role.

([1]) In Chad, the two indicators for the delivery rate to beneficiary structures, while useful, provide for checks based on bills of receipt, which are not sufficient. Goods must be physically inspected.

([2]) The PEFA Steering Committee, on which the Commission is represented, meets twice a year. The results of PEFA's work are brought to the attention of the other main donors in bodies of the OECD.

54. Locally, coordination is generally satisfactory but not always sufficiently structured (see *box 6*). It is constantly evolving because it takes time to build up a voluntary-membership network of donors, more and more of which are granting budget aid. The Commission collaborates closely with the Bretton Woods institutions, which exercise considerable influence and have more substantial resources at their disposal. In the five countries visited, coordination is most advanced in Mozambique, which has the longest experience in this field (see *Annex 4*).

Box 6 — Coordination between donors in the five countries visited

1. *In Ethiopia coordination between donors functions well. The Delegation chairs the informal direct budget support group and is a member of the public finance management committee which holds monthly meetings between donors and the government. All the evaluation work is carried out jointly and Ethiopia, as one of the 18 ACP PEFA pilot countries, is going to test the new performance measurement framework (see paragraph 44).*

2. *The situation in Mozambique provides several examples of good practice and is described in* Annex 4.

3. *In Niger there is no formal structure for coordination between donors, but satisfactory ongoing dialogue has been established between them. The various areas of public finance are divided between the Commission (programming, implementation and budgetary control), the World Bank (procurement and structural reform) and the IMF (macroeconomic framework and monetary matters).*

4. *In Chad representatives of the Commission, IMF, World Bank (WB), African Development Bank (ADB) and the French Development Agency (AFD) meet informally and participate in joint assessments. These donors have differing perceptions of external audit in the country. Whereas the Commission, IMF and AFD want to develop the Chambre des comptes, WB relies on another audit body, Collège de Contrôle et de Surveillance des Revenus Pétroliers (Oil Revenues Control and Monitoring Board — CCSRP), which seeks to maintain safeguards on the use of oil revenue.*

5. *In Zambia coordination functions well. WB, Delegation and other donors encouraged the government to compile the PEMFA (public expenditure management financial accountability) review and the action plan that will follow it. In December 2004 an overall support programme for implementation of the plan was signed by 11 partners. The Delegation and Norway chair the PEMFA donor group. In addition the Delegation is a member of an informal group examining the quality of government expenditure. Lastly, a Memorandum of Understanding was signed in 2004 by eight donors and the government (Framework for harmonisation in practice — HIP), the main aims being donor coordination and harmonisation, donor alignment on government procedures and the government's commitment to undertaking the necessary reforms. The Commission has not yet signed the memorandum.*

55. The Commission does not have access to full information on the budget aid that other donors allocate and disburse in the beneficiary countries. This information is hard to come by because there is no standard definition of budget aid and some donors do not supply information.

Relations with parliaments and Supreme Audit Institutions to be strengthened

56. If public finance management reforms are to succeed, it is crucial that countries assume ownership at all levels, from the official who is expected to follow new procedures to the highest government echelons. Otherwise procedures will be poorly applied or even bypassed. This ownership depends, among other things, on the quality of donors' relations with the national authorities, and above all with the government, the parliament and the Supreme Audit Institution (SAI).

57. The government is the Commission's partner and cosignatory of the budget aid programmes, as well as playing the lead role in designing and implementing the reforms that are intended to improve public finance management.

58. The parliament plays an important part in advancing those reforms, especially where they relate to budget programming and follow-up of the SAI's audit reports. It is of fundamental importance to ensure as far as possible that in carrying out such functions parliament is acting in the country's interest and is not driven exclusively by donor pressure. According to the Commission, the most significant progress is achieved in the countries where the parliaments are most active.

59. The SAI is the external auditor responsible for assessing budget implementation and the reliability of the annual accounts. Even though in most ACP countries it will be years before the SAI is in a position to shoulder its responsibilities fully, the results of SAIs' work must be systematically included ([1]) in the set of information that is made available to donors, but without creating too close a link between those results and the level of aid received.

60. The dialogue with governments is usually formalised and satisfactory ([2]). Parliamentary involvement and the dialogue with the SAIs (see *box 7*), on the other hand, are often insufficient, because of the institutional weakness of these bodies and the weakness of their position vis-à-vis both government and donors.

([1]) The SAIs of several donor countries meet regularly in the context of a coordination body known as HOAP (Harmonisation of Overseas Audit Practice). The aim is to develop a coordinated approach which relies on the work of beneficiary States' SAIs and, with their agreement, audits the use of the budget aid disbursed by their respective (donor) governments.

([2]) The financing proposals and agreements make formal provision for dialogue with the government.

Box 7 — Examples of insufficient dialogue with Supreme Audit Institutions

1. In Ethiopia the donors did not make use of the Auditor General's reports (and reports by internal auditors), which were in Amharic. As a result of the Court's audit visit English translations were to be arranged, so that the reports can be used, and the Auditor General was to join the public finance management committee comprising representatives of donors and the government.

2. In Mozambique, dialogue with the Tribunal administratif (Administrative Court) is difficult. The Tribunal did not consider itself bound by the action in the performance assessment framework (PAF) ([1]) matrix which aims to abolish its ex ante control function. Donors negotiated the matrix with the government and the Tribunal maintains that it may, and must, apply only national legislation.

([1]) Footnote does not concern English version.

61. The Commission, in coordination with other donors, must continue to develop a methodology to provide the SAIs with appropriate institutional support ([1]), and to put in place similar support for parliamentary committees on finance and budgetary control.

62. The government, which is subject to audit by the parliament and the SAI, is not necessarily best placed to discuss measures to strengthen the powers of those two bodies. It is therefore vital, in the context of negotiations with the government of a country, to consider how the Commission can establish better contacts with these two institutions.

Human resources shortfall at the Commission

63. The audit visits showed that the human resources assigned to monitoring public finance reforms were sometimes insufficient.

64. The staff in question are almost always economists (this is also true of other donors' local representatives). While this specialisation is relevant, some diversification would be useful where several members of a Delegation are assigned to budget aid.

([1]) In December 2004, Court staff took part in a seminar organised by the Commission on the theme of developing the capacities of Supreme Audit Institutions.

65. The resources available to the central services are deemed inadequate by the Heads of Unit concerned. The Court considers that changes would be justified in this area in view of the amounts involved and the importance of the activity, and that the situation could be improved by rationalising the use of the available resources ([2]).

66. In addition, certain tasks, such as the analysis of financing proposals and the Delegations' monitoring reports, should be systematised through the introduction of checklists ([3]). These would make it possible to ensure that the work carried out is both comprehensive and homogeneous and would facilitate activity reviews.

67. The Commission should continue its endeavours to provide more extensive public finance training for its employees ([4]).

68. Finally, the pooling of experience and the identification and dissemination of best practice, which has been organised among the West African Delegations, must be extended to other regions.

Situation on the ground: progress on reforms but beneficiary countries' management still very weak

69. The audits in the five countries did not reveal any significant differences between the information provided by the Commission and the situation on the ground (with the exception of the problem referred to in paragraph 38).

([2]) Sharing the monitoring of public finance management between the EuropeAid Cooperation Office (AIDCO) and the Development Directorate-General (DEV) results in a situation that is far from ideal and only works because of good interpersonal relations.

([3]) Standard list of points to be checked in order to ensure that documents have been systematically and fully analysed and to identify who carried out the checks.

([4]) Court staff took part in the three main training courses on budget aid that the Commission organised for its own staff (two courses — introductory and advanced — on macroeconomic budget aid and one on sectoral budget aid).

70. The public finance management systems are affected by numerous weaknesses [1] that are often accentuated in peripheral authorities such as municipalities, and budget aid remains exposed to a significant risk of misuse. However, many important reforms aimed at limiting this risk are being implemented, and the beneficiary States are making an obvious effort in this direction. Progress was noted in the fields of budget programming (more consistent with the poverty reduction strategy), the implementation of revenue [2] and expenditure (in particular the simplification and frequent computerisation of circuits, rationalised cash management and stricter rules on public procurement), the rendering of the accounts (faster) and internal and external audit (see *Box 8*).

Box 8 — Main public finance management reforms in progress in 2004 in the five countries visited

1. In Ethiopia the expenditure management and control programme (EMCP) comprises eight current projects covering the financial legal framework, public expenditure programme, budget reform (programming and monitoring), reform of accounting, financial flows, financial information systems, and internal and external audit.

2. In Mozambique the principal reform concerns the government financial management system (SISTAFE). SISTAFE came into service recently, after some delay, and covers simplification of revenue and expenditure circuits, rationalisation of the Treasury accounts, computerisation of expenditure, budget classification, close and audit of the accounts, general inspection of finance, budget procedures and medium-term programming. In addition to this there has been a reform of procurement procedures and a reform of fiscal and customs revenue. The latter is now in its final stages and domestic revenue has increased from 9 % to around 14 % of gross domestic product from 1996 to 2004.

3. A new budget classification and new chart of accounts have been adopted in Niger and are at the implementation stage. The legal and administrative texts governing the budget cycle are being updated and reforms concerning the collection of revenue, procurement and a supreme audit institution are in preparation.

4. Reforms have been undertaken in Chad, mainly covering the introduction of a medium-term expenditure framework, financial legislation, the introduction of programme budget processes, computerisation and rationalisation of expenditure flows, procurement, fiscal and customs revenue, and the development of management tools.

5. In Zambia a number of reforms are under way as regards the restructuring of services, the civil service pay system, decentralisation and public expenditure management and financial accountability (PEMFA). The latter is split into twelve domains, covering the entire budget cycle. Financial management has already been computerised and in 2004 the government introduced an activity-based budget with a link to medium-term programming and monthly limits for transfers of funds.

71. Given their scope and complexity, these reforms will take time, especially since there are frequently delays owing to the often very limited powers of the departments responsible for implementing them. It is still too early to discern any significant lasting results, although the follow-up implemented by the Commission in particular reveals reasonably positive partial interim results.

Commission's reactions appropriate

72. Every financing agreement is a contract which binds the Commission and the beneficiary country. The Commission may react to changes in the quality of a beneficiary country's public finance management in any of four ways. It may unilaterally suspend a programme, amend it by agreement with the country concerned, take action during the implementation of the programme and influence the design of the subsequent programme. The Commission's reactions are appropriate and consistent with its dynamic approach (see paragraph 28). For example, the Commission suspended payment to Chad of the first (fixed) tranche of 20 million euro following the interruption of the IMF programme [3].

73. Where the payment of a variable tranche is below the specified maximum, the balance remains assigned to the beneficiary country. This reduces the incentive effect of variable tranches. It would be more effective to rule that any balance is lost to the country.

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(1) As well as the general weakness relating to the capacity of government departments in the beneficiary countries, weaknesses often affect, for example, procurement, purchasing follow-up (no materials accounting or inventory), cash management, accounting, management tools and the procedures and resources of internal and external audit bodies.

(2) In practice, government reforms often take account of domestic revenue, but it is not adequately emphasised in the Commission's Guide (see paragraph 24).

(3) The negotiations towards the end of 2003 between the IMF and the government on the sixth review of the programme financed by the poverty reduction and growth facility (PRGF) failed to deliver an agreement. Since the PRGF programme expired on 6 January 2004 and was not extended, Chad was no longer automatically eligible for budget aid under Article 67(4) of the Cotonou Agreement.

74. As public finance management reform is a medium to long-term process, each programme renewal should be taken as an opportunity to adjust the 'conditionalities' of budget aid (preconditions, indicators and weighting of variable tranches) to reflect the progress achieved and new priorities. It is too early to note what reactions there will be at this stage in the five countries visited.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

75. The Court's audits provided the following answers to the questions raised in paragraph 19.

76. The Commission has defined a **methodological framework** to enable it to assess the initial situation and subsequent development of the beneficiary countries' public finance management (see paragraphs 23 and 41). This framework is a significant advance in terms of the situation that existed before, but it is incomplete (see paragraphs 24 and 26) and lacks precision (see paragraph 25). It does not help to explain the cohesion and logical relationship between aid programmes (see paragraph 30). The Guide is not updated (see paragraph 27). The instructions concerning monitoring reports are also incomplete, although the Commission has already introduced significant improvements (see paragraph 42).

77. During the initial stage, this methodological framework was **implemented** in a reasonably satisfactory manner, despite the inadequate attention given to corruption, the lack of recommendations by the Heads of Delegation and, on occasion, the lack of an overall institutional support framework (see paragraphs 31 to 37). Matters are less satisfactory at the follow-up stage, where the Delegations' reports are overly static and incomplete and the performance indicators sometimes offer too little incentive (see paragraphs 47 to 51).

78. These processes are complex and awkward to implement, because they apply to sovereign States whose ownership of the reforms is a criterion for success for which the Commission can press but over which it has no control.

79. Similarly, the Commission has no control over coordination among donors, although it plays a leading role at headquarters level, mainly with the World Bank, in the context of PEFA (see paragraph 43). In ACP countries coordination nevertheless continues to be more problematic and there is a risk of this affecting implementation of the PEFA Measurement Framework in these countries.

80. The information on which the financing decisions were based and, subsequently, the information in the follow-up documents, **give a true view of the situation**. For this reason, the Commission is usually well informed about the weaknesses affecting public finance management systems (see paragraphs 38 and 69 to 71).

81. The Commission's financing **decisions**, and its **reactions** in mid-programme, are appropriate in the light of its dynamic interpretation of Article 61(2) of the Cotonou Agreement (see paragraph 28). However, since this increases the level of risk, at least in the short term, it is doubly important for the Commission to monitor the situation rigorously.

82. Meanwhile, the Commission's **decisions** are insufficiently argued (see paragraph 39). The financing proposals and agreements do not make sufficiently clear the relations between the weaknesses detected in public finance management, governments' reform programmes, the institutional support required for implementation of those reforms and the follow-up tools, including preconditions and performance indicators (see paragraph 30). This failure to evidence cohesion and perspective, combined with a presentation that is too diverse and unstructured, do not provide the EDF Committee with assurance that all the weaknesses are being taken into consideration (see paragraphs 32 and 33).

83. The reforms accompanying direct non-targeted budget aid require a good deal of time. It is still too early to discern any significant lasting results, although the follow-up implemented by the Commission in particular reveals reasonably positive partial interim results (see paragraphs 69 to 71). For example, the risks to which budget aid is exposed (see paragraph 12), and which are a matter of concern to the Parliament and the Council (see paragraph 2), largely continue to apply. The recommendations that follow should make it possible to improve the management of those risks.

Recommendations

84. The Commission should update its Methodological Guide to the programming and implementation of budgetary support for third countries by incorporating into it the relevant instructions issued since March 2002 (see paragraph 27), in order to ensure that within each aid programme there is cohesion between the weaknesses recorded, the reforms that are to mitigate them, institutional support and follow-up tools (see paragraph 30). In addition, more attention must be given to matters relating to domestic revenue, including revenue from public undertakings (see paragraph 24), and to corruption (see paragraph 34). The Guide should also include improvements in connection with the Delegations' monitoring reports (see paragraph 42).

85. The Commission should demonstrate in a more formalised and structured manner, setting out the reasons leading to its conclusion that the direction being taken by a beneficiary country is satisfactory, that there is compliance with Article 61(2) of the Cotonou Agreement, account being taken of the public finance management weaknesses revealed by the initial assessment (see paragraphs 39 and 40).

86. The Commission should make use of performance indicators that genuinely encourage beneficiary countries to press ahead with their reforms and that focus more closely on results that reflect improvements in management (see paragraph 49).

87. The Commission must do everything within its power to see to fruition the public financial management performance measurement framework being developed within the framework of PEFA (see paragraph 43). This major coordination project between donors must be improved by taking account of the results that will be available at the end of the testing stage. The Court's suggestions should also be considered (see paragraph 7 in *Annex 2*), especially the proposal concerning tests of controls. It is crucial that donors (particularly those belonging to the partnership) adopt and implement the Framework in the near future.

88. Coordination between donors' local representatives should be strengthened as regards the production of assessments, evaluations and audits, the implementation of institutional support and the use of conditions and performance indicators, it being understood that each donor retains full discretion over its own aid disbursement (see paragraph 54).

89. Relations with the authorities in the beneficiary States should be systematically structured and taken beyond the government level to include parliaments and Supreme Audit Institutions, whose powers must be strengthened to enable them to undertake the reforms that concern them and to audit those that are a matter for the executive branch. It is therefore vital, in the context of negotiations with the government of a country, to consider how the Commission might approach parliaments and SAIs (see paragraphs 56 to 62).

This report was adopted by the Court of Auditors in Luxembourg at its meeting of 29 and 30 June 2005.

For the Court of Auditors
Hubert WEBER
President

ANNEX 1

SIX TABLES ILLUSTRATING THE IMPORTANCE OF BUDGET AID

Table A

Relative importance of budget aid (1) in EDF aid (commitments and payments), 1999 to 2004

(million euro)

	Year	Total budget aid (2)	Total EDF aid	**Budget aid as a proportion of EDF aid**
		A	B	**C = (A / B)**
Commitments	1999	276,93	2 693,00	**10,28 %**
	2000	1 350,20	3 757,41	**35,93 %**
	2001	386,50	1 554,16	**24,87 %**
	2002	595,60	1 768,39	**33,68 %**
	2003	972,80	3 395,83	**28,65 %**
	2004	469,40	2 375,15	**19,76 %**
Payments	1999	206,48	1 275,00	**16,19 %**
	2000	587,62	1 548,16	**37,96 %**
	2001	672,90	2 067,86	**32,54 %**
	2002	570,21	1 852,72	**30,78 %**
	2003	615,20	2 179,47	**28,23 %**
	2004	724,42	2 197,84	**32,96 %**

(1) In the form of structural adjustment before the Cotonou Agreement entered into force.
(2) Includes highly indebted poor countries initiative (HIPC).
Source: Commission figures.

Table B

Relative importance of direct non-targeted budget aid for 2003 and 2004

(million euro)

	2003		2004	
	Commitments	Payments (1)	Commitments	Payments (1)
A. Direct non-targeted budget aid	666,80	358,11	425,80	461,90
B. Direct targeted budget aid	106,00	40,10	0,00	136,00
C. Indirect budget aid	0,00	8,02	43,60	26,52
D. Total budget aid excluding HIPC Initiative (A + B + C)	**772,80**	**406,23**	**469,40**	**624,42**
E. HIPC Initiative (2)	200,00	208,97	0,00	100,00
F. Total EDF budget aid (D + E)	**972,80**	**615,20**	**469,40**	**724,42**
G. Total EDF aid	**3 395,83**	**2 179,47**	**2 375,15**	**2 197,84**
Direct non-targeted budget aid as a proportion of total EDF budget aid (A / F)	68,54 %	58,21 %	90,71 %	63,76 %
Direct non-targeted budget aid as a proportion of total EDF aid (A / G)	19,64 %	16,43 %	17,93 %	21,02 %

(1) Payments are booked to the commitments for the year or the commitments outstanding from previous financial years.
(2) The HIPC (Heavily Indebted Poor Countries) Initiative seeks to ease the external debt of the countries concerned. It has a similar impact to budget aid but is not subject to the same audit arrangements. The commitments and payments are entered in the EDF accounts by the EDF when they are effected to the European Investment Bank (EIB) and the World Bank (WB).
Source: Commission data.

Table C

Total EDF budget aid (commitments and payments) by country, 2003 and 2004 (excluding HIPC)

(million euro)

Country	2003		2004	
	Commitments	Payments [1]	Commitments	Payments [1]
Benin	55,00	4,29	0,00	18,20
Burkina Faso	0,00	37,80	0,00	37,57
Burundi	0,00	8,02	43,60	26,52
Cameroon	0,00	8,86	0,00	0,00
Cape Verde	0,00	9,00	5,80	5,50
Djibouti	0,00	4,50	0,00	0,00
Ethiopia	0,00	10,70	95,00	45,00
Ghana	0,00	25,57	62,00	27,85
Guyana	0,00	0,00	23,30	6,00
Jamaica	30,00	0,00	25,00	36,10
Kenya	0,00	0,00	125,00	0,00
Lesotho	0,00	3,00	0,00	5,50
Madagascar	0,00	34,50	35,00	20,67
Mali	132,90	32,92	0,00	29,60
Mauritania	0,00	5,70	0,00	6,00
Mozambique [2]	16,40	41,00	0,00	51,10
Niger [2]	90,00	24,25	0,00	27,25
Uganda	0,00	24,50	0,00	24,50
Central African Republic	0,00	0,00	0,00	11,90
Democratic Republic of the Congo	106,00	4,60	0,00	105,70
Rwanda	50,00	25,04	0,00	12,50
São Tomé and Príncipe	0,00	1,00	0,00	0,00
Senegal	0,00	3,80	53,00	25,30
Sierra Leone	0,00	0,00	0,00	18,37
Tanzania	114,00	68,50	0,00	31,50
Chad	50,00	0,00	0,00	0,00
Vanuatu	0,00	0,00	1,70	0,80
Zambia [2]	128,50	28,68	0,00	50,99
Total	**772,80**	**406,23**	**469,40**	**624,42**

[1] Payments are booked to the commitments for the year or the commitments outstanding from previous financial years.

[2] Payments in 2004 include the variable tranches for Mozambique (9,1 million euro), Niger (8,25 million euro) and Zambia (29,5 million euro).

Source: Commission data.

Table D

Relative importance of budget aid (EDF and other donors) in the national budget in 2004 for the five countries visited

(million euro)

Country	National budget (1)	Budget aid paid by the Commission	Budget aid paid by the other donors	Total budget aid paid	Budget aid paid as a proportion of total
	A	B	C	D = B + C	D / A
Ethiopia	2 924,00	45,00	236,38	281,38	9,62 %
Mozambique	1 202,10	51,10	139,15	190,25	15,83 %
Niger	621,83	27,25	44,07	71,32	11,47 %
Chad	603,28	0,00	22,00	22,00	3,65 %
Zambia	1 475,66	50,99	215,00	265,99	18,03 %

(1) The budget figure for Chad relates to 2003.

Source: Commission data.

Table E

Proportion of budget aid relative to total aid paid by principal donors in 15 African countries (1) in 2003

Donor	Budget aid as a proportion of total aid
World Bank (2)	48,1 %
United Kingdom	34,2 %
European Commission	30,7 %
Netherlands	27,8 %
Sweden	21,5 %
Switzerland	19,2 %
African Development Bank	16,5 %
Italy	16,0 %
Ireland	15,2 %
Norway	14,5 %
Canada	12,0 %
Denmark	10,1 %
Germany	6,4 %
Finland	3,9 %
France	2,3 %
Japan	1,0 %
Weighted average	**25,7 %**

(1) The 15 countries are: Benin, Burkina Faso, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mali, Mozambique, Niger, Uganda, Rwanda, Senegal, Sierra Leone and Tanzania.

(2) The World Bank aid essentially consists of loans.

Source: SPA — Strategic Partnership with Africa — Survey of the alignment of budgetsupport and balance of payments support with national poverty reduction strategy processes — final draft dated 7 February 2005.

The figures in the above document are rough estimates.

Table F

Budget aid disbursed by various donors in 2004 in the five countries visited

(million euro)

Donor	Ethiopia		Mozambique		Niger		Chad		Zambia	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
European Commission	45,00	16,0 %	51,10	26,9 %	27,25	38,2 %	0,00	0,0 %	50,99	19,2 %
World Bank ([1])	100,00	35,5 %	49,80	26,2 %	22,26	31,2 %	20,00	90,9 %	16,00	6,0 %
International Monetary Fund ([1])	0,00	0,0 %	0,00	0,0 %	10,18	14,3 %	0,00	0,0 %	199,00	74,8 %
African Development Bank	66,67	23,7 %	0,00	0,0 %	4,63	6,5 %	0,00	0,0 %	0,00	0,0 %
Germany	6,00	2,1 %	3,50	1,8 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Belgium	0,00	0,0 %	3,00	1,6 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Canada	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Denmark	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Finland	0,00	0,0 %	4,00	2,1 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
France	0,00	0,0 %	3,00	1,6 %	7,00	9,8 %	2,00	9,1 %	0,00	0,0 %
Ireland	6,80	2,4 %	6,00	3,2 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Italy	0,00	0,0 %	3,20	1,7 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Japan	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Norway	0,00	0,0 %	7,18	3,8 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Netherlands	0,00	0,0 %	18,00	9,5 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Portugal	0,00	0,0 %	1,53	0,8 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
United Kingdom	45,00	16,0 %	22,44	11,8 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Sweden	11,91	4,2 %	11,00	5,8 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Switzerland	0,00	0,0 %	6,50	3,4 %	0,00	0,0 %	0,00	0,0 %	0,00	0,0 %
Total	**281,38**	**100,0 %**	**190,25**	**100,0 %**	**71,32**	**100,0 %**	**22,00**	**100,0 %**	**265,99**	**100,0 %**

([1]) Loans as aid.
Source: Commission data.

ANNEX 2

THE DRAFT NEW PUBLIC FINANCE MANAGEMENT PERFORMANCE MEASUREMENT FRAMEWORK

1. The Delegations' monitoring reports rely on existing diagnoses and evaluations. The main tools traditionally used to measure the quality of public finance, which in many cases were developed by the International Monetary Fund and the World Bank, are the country financial accountability assessment ([1]) (CFAA), public expenditure review ([1]) (PER), report on the observance of standards and codes ([1]) (ROSC), country procurement assessment report ([1]) (CPAR), highly indebted poor country assessment and action plan ([1]) (HIPC AAP), fiduciary risk assessment ([1]) (FRA), and public expenditure tracking survey ([1]) (PETS). In some countries, such as Ethiopia, donors have developed substitute tools locally.

2. In the face of this plethora of assessments, which were unwieldy to implement and at times difficult to exploit, rationalisation, in the form of a single report, became necessary. This new tool is intended as a replacement for the existing ones, not a supplement, and is meant to be used by all donors and applicable to all countries (not just ACP countries). It should provide a sufficiently comprehensive view of a country's public finance management, covering amongst other things all the major risks associated with programming and budget execution, the presentation of accounts and internal and external audit.

3. It was for this reason that, in 2004, PEFA (Public Expenditure Financial Accountability) ([2]) started work on a new public finance management performance measurement framework (the measurement framework). The core of this tool is a set of 28 indicators that aim to assess the adequacy and performance of public finance management procedures, systems and institutions (see *table G*).

Table G

Set of public finance management performance indicators developed by the PEFA (Public Expenditure Financial Accountability) partners

A.	**PUBLIC FINANCE MANAGEMENT OUT-TURNS**
1.	Aggregate fiscal deficit compared to original approved budget.
2.	Composition of budget expenditure out-turn compared to original approved budget.
3.	Aggregate revenue out-turn compared to original approved budget.
4.	Stock of expenditure arrears; accumulation of new arrears over past year.
B.	**KEY CROSS-CUTTING FEATURES: COMPREHENSIVENESS AND TRANSPARENCY**
5.	Comprehensiveness of aggregate fiscal risk oversight.
6.	Extent to which budget reports include all significant expenditures on central government activities, including those funded by donors.
7.	Adequacy of information on fiscal projections, budget and out-turn provided in budget documentation.

([1]) Footnote does not concern English version.

([2]) PEFA was set up in 2001 as a partnership between the World Bank, the European Commission, DFID (the United Kingdom Department for International Development), the Swiss State Secretariat for Economic Affairs, the French Ministry of Foreign Affairs, the Norwegian Ministry of Foreign Affairs and the International Monetary Fund. The Commission is a founder member and one of the leading players.

8.	Administrative, economic, functional and programmatic classification of the budget.
9.	Identification of poverty related expenditure in the budget.
10.	Publication and public accessibility of key fiscal information, procurement information and audit reports.
C.	**BUDGET CYCLE**
C (i)	*Medium term planning and budget formulation*
11.	Extent of multi-year perspective in fiscal planning, expenditure policy-making and budgeting.
12.	Orderliness and participation in the budget formulation process.
13.	Coordination of the budgeting of recurrent and investment expenditures.
14.	Legislative scrutiny of the annual budget law.
C (ii)	*Budget execution*
15.	Effectiveness of cash flow planning, management and monitoring.
16.	Procedures in operation for the management and recording of debt and guarantees.
17.	Extent to which spending ministries and agencies are able to plan and commit expenditures in accordance with original/revised budgets.
18.	Evidence available that budgeted resources reach spending units in a timely and transparent manner.
19.	Effectiveness of internal controls.
20.	Effectiveness of internal audit.
21.	Effectiveness of payroll controls.
22.	The existence of a transparent procurement system as an integral part of the overall PFM system which is supported by a clear regulatory framework that provides for competition, value for money and effective controls.
C (iii)	*Accounting and reporting*
23.	Timeliness and regularity of data reconciliation.
24.	Timeliness, quality and dissemination of in-year budget execution reports.
25.	Timeliness and quality of the audited financial statements submitted to the legislature.
C (iv)	*External accountability, audit and scrutiny*
26.	The scope and nature of external audit.
27.	Follow up of audit reports by the executive or audited entity.
28.	Legislative scrutiny of external audit reports.

Source: PEFA. Revised Consultative Draft Public Finance Management Performance Measurement Framework, 12 February 2004, Public Expenditure Working Group.

4. There are two limits to this approach, both of them known to and accepted by donors. Firstly, it does not lead to recommendations, which would probably require a more thorough investigation into the causes of the problems identified. Secondly, it does not address the issue of the effectiveness and efficiency of public finance.

5. The indicators, measured against a scale from A (best possible) to D, are qualitative and usually cover a fairly large area that can be broken down into several parts. For example, the assessment against indicator 22, concerning the existence of transparent procurement systems for services, works and goods, calls in particular for review of the regulatory framework, the correct application of the rules (e.g. publication of calls for tender), the effectiveness of control systems and a comparison between prices paid by the public sector and market prices in the private sector.

6. The standard report proposed by the measurement framework suggests that these indicators should be accompanied by more general information about the country and its management systems, and in particular by a description of the government programme of public finance management reforms, indicating to what extent the reforms cover the weaknesses identified by means of the indicators.

7. The following proposals for improvements resulted from the measurement framework: review:

(a) some indicators include assessment of management or control systems. The evaluation of systems deemed to be weak may be restricted to interviews and limited inspections. However, to conclude that a system is effective it is crucial to rely on more thorough checks, including tests of controls ([1]);

(b) a systematic description of the causes of weaknesses that can be identified without significant further investigation would be useful in order to improve the targeting of governments' reform programmes, which aim to remedy such weaknesses;

(c) twelve indicators would rely on, among other things, indices (representing variances, times, amounts or percentages) (see *table H*). The results of these indices should systematically appear in the assessment reports, and some of them could be used as performance indicators in the Commission's programmes;

(d) indicator 3, on public revenue, should include a comparative analysis of domestic revenue actually received and the amount that could reasonably be expected given the activity of the country (for example, by comparing import levels and customs revenue);

(e) indicator 25, on audited financial statements, provides for examination of the audit opinion on them issued by the Supreme Audit Institution (SAI). It would also be helpful to examine the SAI's work and opinions on the legality and regularity of the underlying transactions and on sound financial management, although these elements should be treated with caution;

(f) indicator 26, on external audit, should include an analysis of the adequacy of the SAI's resources to its audit tasks;

(g) an additional indicator should be added with a view to evaluating the existence and quality of the services entered in the accounts, including, where purchasing is centralised, the problem of their delivery as far as the final beneficiaries ([2]);

(h) an additional indicator should be added with a view to evaluating anti-corruption measures by examining what is being done to identify, analyse and combat corruption ([3]).

([1]) Tests of controls, which were previously known as compliance tests, are a part of internationally recognised auditing standards. See in particular International Federation of Accountants (IFAC), ISA (International Standards on Auditing) 330, 430 and 530.

([2]) The delivery rate to final beneficiaries of centrally purchased goods could be used as an index for this indicator.

([3]) Perception indicators such as those of Transparency International could be used as indices for this indicator.

Table H

Cardinal data (indices) linked to the indicators, as proposed in the measurement framework

Indicators in question	Cardinal data (indices)
1	— Deviation from budgeted aggregate fiscal deficit as percent of budgeted expenditure. — Deviation from budgeted primary fiscal balance (before interest) as percent of budgeted expenditure.
2	— Average deviation between actual and budgeted expenditure by functional classification — Average deviation between actual and budgeted expenditure by economic classification — Average deviation between actual and budgeted expenditure on administrative basis — Budget volatility (median of year-to-year policy changes in each functional or administrative classification over the preceding 4 years: policy change is reflected by change in percentage share in the budget)
3	— Actual revenue minus budgeted revenue as a percent of budget
4	— Level of expenditure arrears as a percentage of total expenditure
10	— Number of days after quarter end that quarterly budget report made public
14	— Number of days the legislature has to review the budget
18	— Percentage of intended resources that reach front-line service delivery units
19	— Error rates in routine financial transactions
22	— Prices paid by public sector for goods, works and services is comparable to prices paid by the private sector for similar items
24	— Number of days following end of quarter that quarterly budget report is disseminated within the government.
25	— Number of months after year end that financial statements presented to legislature
26	— Number of months following external audit report before specialized legislative committee completes examination of the report

Source: PEFA. Revised Consultative Draft Public Finance Management Performance Measurement Framework, 12 February 2004.

ANNEX 3

THE PERFORMANCE INDICATORS USED BY THE COMMISSION

1. Section 3.7 of the Guide provides a good deal of detail concerning the selection and use of performance indicators. It provides in particular that 'as far as possible, the indicators should be identified in the PRSP (Poverty Reduction Strategy Paper) or the government's policy documents and should be shared by the other donors' and specifies that the indicators must be SMART (Specific — Measurable — Accepted by all involved — Realistic — Timed).

2. The performance indicators included in the Commission's programmes can be classified in various areas, chief of which are social sectors such as health and education and public finance management (PF indicators). This audit focuses only on the last category. Annex 13a to the Guide provides, as an example, around 40 performance indicators, seven of which are specific to public finance (see *table I*).

Table I

List of seven public finance performance indicators proposed as an example in Annex 13a to the Commission Guide

Gap between budget allocations and objectives set at sectoral level
Budget execution rate (total and by priority sector)
Share of the budget going to more peripheral structures (by survey)
Unit costs of consumer items under public contracts/unit cost of local purchases from private sector (or donors) (by survey)
Time taken to pay suppliers
Percentage of bad execution (procedures not adhered to)
Delay in closure of accounts and approval of the national accounts

3. The tendency is to establish jointly with the government and donors a list of indicators from which each selects the ones that they particularly want to use. The objectives are to determine indicators that are accepted wholeheartedly by the country and to avoid having a large number of different indicators for each donor.

4. The performance indicators adopted (type and number) were decided on a case-by-case basis. The number is usually an expression of the volume of variable tranches linked to public finance (see *table J*).

Table J

Relative importance of performance indicators in the variable tranches for the five programmes examined

(million euro)

	Variable tranches				Performance indicators			
	Total amount	Amount linked to public finance indicators	Amount linked to sectoral indicators	Public finance as proportion of total amount	Total number	Number of public finance indicators	Number of sectoral indicators	Public finance indicators as proportion of total number
	A	B	C	D = B / A	E	F	G	H = F/E
Ethiopia	30	6	24	20 %	15	3	12	20 %
Mozambique	42	21	21	50 %	22	8	14	36 %
Niger	35	16	19	46 %	18	7	11	39 %
Chad	26	22	4	85 %	28	20	8	71 %
Zambia	100	65	35	65 %	23	12	11	52 %

Source: Financing agreements.

5. According to the Commission, the proportion of variable tranches (see *table K*) is increased if the national authorities' willingness to improve their public finance management deserves encouragement.

Table K

Relative importance of variable tranches in the five programmes examined

(million euro)

	Total amount for programme	Budget support				Related expenditure	
		Total tranches	Fixed tranches	Variable tranches		Institutional support	Audits
	A = B + F + G	B = C + D	C	D	E = D/B	F	G
Ethiopia	95	90	60	30	33 %	3,5	1,5
Mozambique	168	162	120	42	26 %	5,5	0,5
Niger	90	88	53	35	40 %	1,35	0,65
Chad	50	46	20	26	57 %	3,7	0,3
Zambia	117	110	10	100	91 %	6,75	0,25

Source: Financing agreements.

6. Of the five countries visited three have already received variable tranches. On each occasion the amount disbursed was less than the projected maximum, on account of the PFM performance indicators (see *table L*).

Table L

Impact of performance indicators on the amount of the variable tranches disbursed in the countries visited

(million euro)

Category of performance indicators	According to financing agreement		According to assessment		
	Number of indicators provided	Maximum amount provided	Number of indicators achieved	Amount disbursed	Amount not disbursed
2003 variable tranche of Mozambique programme					
Public finance	8	5	5	3,50	**1,50**
Social sectors	14	5	9	3,20	1,80
TOTAL	22	10	14	6,70	3,30
2004 variable tranche of Mozambique programme					
Public finance	8	7	4	4,20	**2,80**
Social sectors	14	7	10	4,90	2,10
TOTAL	22	14	14	9,10	4,90
2004 variable tranche of Niger programme					
Public finance	5	8	3	4,50	**3,50**
Social sectors	7	8	4	3,75	4,25
TOTAL	12	16	7	8,25	7,75
2004 (2nd) variable tranche of Zambia programme					
Public finance	11	30	5 (*)	8,25	**21,75**
2004 (3rd) variable tranche of Zambia programme					
Public finance	8	10	5	5,00	**5,00**
Social sectors	8	20	7	16,25	3,75
TOTAL	16	30	12	21,25	8,75
GRAND TOTAL	**83**	**100**	**52**	**53,55**	**46,45**

(*) Of these five indicators, four were only partially achieved.

Source: Assessment documents for the tranches disbursed.

ANNEX 4

MOZAMBIQUE, AN EXAMPLE OF GOOD PRACTICE IN INTER-DONOR COORDINATION

1. Coordination between donors and with the government is governed by a memorandum of understanding (MoU) which was signed in April 2004 and had 16 adherents at the end of 2004. The agreement includes a matrix (PAF — performance assessment framework) for monitoring the progress of the reforms, combined with activities/indicators covering a three-year period (2004 to 2006) and subject to annual review.

2. In principle the donors agree not to use any performance indicators that are not included in the matrix (but there are exceptions, notably in the case of the Commission, which had already included its own indicators in its programme before the MoU was signed).

3. There is also another matrix setting out donors' undertakings vis-à-vis the government. It comprises some twenty activities, which are grouped into six areas: predictability of budget aid; alignment and harmonisation of indicators; reducing the administrative burden caused by missions; transparency; coordination of capacity building; adjustment of the amounts paid in the form of budget aid.

4. The donors in the group take it in turns to chair the group (Switzerland had the chair at the time of the mission) with a 'troika' of the last, present and next chairs.

5. The dialogue with the government takes the form of a steering committee made up of representatives of the government and the 'troika +', i.e. the troika (of chairs) plus, as permanent members, the World Bank and the Commission. It meets every two months and more frequently during the periods of the joint reviews, in April and September.

6. In order to lessen the administrative burden the donors have undertaken not to carry out audits or assessments apart from the two joint reviews.

7. Meetings between donors are organised at three levels: heads of mission (policy matters), heads of cooperation (identifying priorities), and economists (technical monitoring).

8. The economists work in subject groups, with responsibility shared between the donors. The 'public finance' area comprises the following groups: the government integrated financial management system (SISTAFE), revenue (taxes and customs duties), procurement and audit. The Delegation is responsible for the audit group and participates actively in all the others, with the exception of the revenue group, where it holds a watching brief.

9. Alongside the public finance area there are other groups on: budget analysis (the Delegation is a contributor), monitoring the poverty reduction programme, public sector reform (including the corruption aspect), etc. The Delegation is considering joining the public sector reform group as an observer (because it does not contribute to the funding of the activities).

10. The public finance management assessment (PFMA) established in September 2004 was carried out using the PEFA framework (see *Annex 2*) and, furthermore, it was carried out jointly with the government.

THE COMMISSION'S REPLIES

SUMMARY

I. The purpose of budget aid is to encourage growth and relieve poverty. The donors who use it believe that, given certain conditions of eligibility, it is more effective than other kinds of aid in strengthening governments' ability to plan and implement macroeconomic, sectoral and public finance reforms. From this point of view, budget aid also provides a response to the risks that might affect external funding based on project aid. It is thus multi-dimensional. Budget aid provided by the Commission to the ACP countries is as much concerned with questions of health or education as with the equally vital question of public finance. The Court's report deals with this latter aspect and must be viewed within this broader context.

II. Generally speaking, the Commission is willing to provide aid to countries with weak administrative structures, in the field of public finance as in many other areas, given that the precise purpose of development is to alleviate such weaknesses. As the Court points out, the Commission, over the years, has substantially improved its ability to monitor the public finance situation, often taking the initiative in relation to the other donors.

III. The Commission defines risk as 'anything that may stand in the way of achieving the objectives' (SEC(2004) 318 of 12 March 2004). Risks should accordingly be assessed in the light of the stated ambitions and aims. It is therefore difficult to identify risks without taking account of the ultimate objective (combating poverty) and the multiple dimensions of this type of support.

IV. The Commission agrees with the Court on the progress made by the Commission in developing analytical and monitoring tools which have enabled it to provide accurate information and to take appropriate action. Of course, improvements can still be made, taking into account the cost-benefit ratio of such improvements, the balance between controls and action by the Commission, and the importance to be attached to the other dimensions of a programme (the Commission places very great importance on the social sectors when providing budget aid).

V. The Commission generally accepts the Court's recommendations, which correspond to actions already being taken.

(a) The Methodological Guide is currently being updated and should be finalised in 2005.

(b) It will clarify the question of country eligibility.

(c) The search for enhanced-incentive performance indicators is an ongoing process.

(d) and (e) The work of PEFA is currently being finalised and the Commission has played and will continue to play a major role in the coordination of the various donors, including at local level, in matters of public finance management.

(f) The Commission is planning to increase the role of parliaments and SAIs, with due regard for the independence of the powers of the various institutions and in the light of the Cotonou Agreement.

INTRODUCTION

1. In line with the recommendations of Special Report No 5/2001, the Commission has moved towards non-targeted budget aid, among other things.

2. As noted by the Court in Special Report No 5/2001 (paragraph 62, recommendation 1(e)), the Commission cannot be held responsible for the management errors of the national departments that execute national budgets. On the other hand, it has a duty to monitor the management of public finance very closely, and that is precisely what it is doing.

AUDIT FIELD: DIRECT NON-TARGETED BUDGET AID

3 to 6. Budget aid is intended to provide countries with the resources they need to reduce the poverty of their people. To this end, it provides support for the introduction of essential reforms. The Commission must verify that all the conditions imposed on the recipient have been met before effecting payment of this aid to the beneficiary State. In line with the practice of the other donors (especially the Bretton Woods Institutions), such aid is normally no longer targeted.

7. Community aid is generally provided in support of the PRSP. Since 2000 aid has taken a new, results-based form. The amount of the support varies (variable tranche) depending on the extent to which objectives in terms of improved services (vaccination, births attended by skilled health personnel, school attendance, etc.) or improved public finances have been achieved. It is this last category which is considered in this report.

9. Budget aid provides the donors which use it with the necessary legitimacy to hold a serious dialogue with the countries concerned on the way in which State resources as a whole are managed. It is very much more ambitious than project aid, the impact of which is generally limited to the proper implementation of an investment project.

10. While projects introduce parallel procedures which are difficult for the beneficiary States to manage, budget aid reinforces national procedures.

11. Although complicated for donors to implement, this type of aid is certainly simpler for the beneficiary countries. It thus limits the inefficiencies associated with the proliferation of procedures or the dispersal of projects.

12. The Commission feels that, when the conditions are met, budget aid offers considerable advantages for the European taxpayer which justifies the risks associated with the weakness of national public finance systems. Moreover, it takes very seriously the risk that the budget aid will not have any impact on reducing poverty. It manages this risk by imposing prior conditions on such aid. It can also terminate or reduce ongoing aid in the light of the country's performance. In short, the Commission, from the adoption of a programme to its implementation, endeavours to set up appropriate means of control at a cost which is reasonable in relation to the risks and to the human resources at its disposal (see reply to paragraphs 63 and 65 below).

13. Improving the management of public finance is an essential element of development; it lies at the heart of budget aid and is specifically designed to improve transparency, reliability and efficiency. Improving public finance management helps to reduce poverty.

14. The question of aid dependency is a general problem which extends beyond budget aid. The variable tranche system is regarded by the OECD as best practice for limiting the volatility of such aid.

15. The risk associated with budget aid is managed by imposing conditions on the planning and implementation of such aid. These include the eligibility conditions set out in the financing proposal, start-up conditions, and the implementing conditions contained in the financing agreement, which enable the Commission to decide whether or not to provide this type of aid, to suspend it during implementation or to increase or reduce the amount involved.

THE COURT'S AUDIT

19(a), (b), (c) and (d). The Court's investigation concentrates on the management of public finances. Although this is a very important dimension for the Commission, it is not the only one. When aid is being planned and, then implemented, we are looking, as well, at other very important elements, such as the macroeconomic situation, health and education policies, the country's ability to monitor the performance indicators, and the quality of the PRSP. The risks involved in external aid are described in the Commission's document SEC(2004) 318 as 'anything that may stand in the way of achieving the objectives'. These risks must therefore be viewed 'always in relation to the ultimate objectives to be achieved'.

20. Although the Court's audit does not seek to assess the impact of budget aid on poverty reduction, the Commission would point out that the Court's recommendations and analyses must also be examined in the light of the necessary balance which has to be preserved between the various areas covered by budget aid, including its final objective. In some countries it may be justified to pay as much attention to the vaccination of children or attendance at health centres as to public finance. This explains the differences in the importance placed on the health, education and public finance indicators, depending on the country.

AUDIT FINDINGS

23. The guide, which, as the Court points out, was a significant improvement on the previous situation, was intended to evolve and is currently being revised. The revision of the question of public finance management was awaiting the Court's findings.

24. The question of revenue is important. It forms part of all the programmes supported by the Commission and will be included in the PEFA indicators. It is monitored by the IMF in allocating roles between donors. The Commission does not want to duplicate the work done by this institution and is concentrating on those areas where it can provide real added value.

25. The structure of the part of the financing proposals dealing with public finances can be improved, but the process must remain within the limits set by the optimum balance between different parts of the programme and should not be at the expense of information concerning the social sectors.

26. The need to observe the eligibility criteria can be made more explicit than it is at present.

27. The contents of the guide have been regularly updated in the form of instruction notes to the Delegations. The most important notes are also on the Commission's intranet site. It is planned to consolidate them in the next version of the guide and to develop the site.

28. Like the other donors providing budget aid, the Commission bases its decisions on proposals and eligibility for budget support on an analysis of the initial situation and the credible prospects for improvement. This analysis leads the Commission to be selective in providing aid.

29. This dynamic interpretation of Article 61(2) could increase the risk in the short term. However, the selective approach to which it leads, based on the rigour (acknowledged by the Court) of the diagnostic assessments and the desire for reform on the part of the beneficiary countries and, coupled with an improvement in their financial situation, makes it possible to contain and to manage this risk. The Commission also feels that, by acquiring a thorough knowledge of the initial situation and the credible prospects for improvement, there is a greater probability that budget aid will have an impact both by improving public finances and by reducing poverty.

30. The cohesion called for by the Court will be made more explicit by maintaining not only a reasonable balance between the Commission's tasks of control and description and the action it takes, but also a balance between the different parts of a financing proposal (in particular those relating to the social sectors). Finally, the Commission will continue to give preference to an approach targeted on those aspects of the reform programme which it feels should be prioritised in the short and medium term, giving reasons for its priorities.

32. The Court comments that, generally speaking, the bulk of information is given in the financing proposals. An effort will be made to ensure that such information is less dispersed and more standardised and structured, and that the links are clearer, while remaining within the realms of what is reasonable.

33. As the Court points out, the financing proposals include the essential reforms. It is difficult to be completely exhaustive in describing these reforms, especially as the same exercise would have to be carried out for the other sectors covered by the financing proposal: macroeconomic situation, health, education, statistics, follow-up, evaluation of the PRSP, to mention only the sectors which are systematically included. It is not certain either that systematically comprehensive descriptions provide real value added.

34. Corruption is a scourge to which the Commission gives its full attention. The fight against corruption is also covered by Article 9 of the Cotonou Partnership Agreement. The question of corruption therefore occupies a central role in cooperation rather than forming part of a separate instrument. Moreover, a standard clause on combating fraud and corruption is included in all standard financing agreements, including the one used for budget aid. As the Court points out, the enormous advantage of budget aid is that it tackles one of the principal potential sources of corruption in many ACP countries: public finance management. The Commission will provide in the financing proposals the information at its disposal on other areas of corruption (the legal system, the police, the Supreme Audit Institution (ISC), etc.), provided that such information is considered to be serious and credible.

35 and 36. The existence of formalised plans describing institutional requirements and support is desirable in all sectors. These plans are the responsibility of the States. The Commission helps in their preparation and will continue to do so. However, such plans do not always exist, are not always comprehensive and are difficult to keep permanently up to date. When providing help in drafting these plans, the Commission tries to ensure that the priorities are clearly identified, including those for which EDF financing is provided.

37. The favourable opinion of the Heads of Delegation, required by the Guide, is given implicitly at the point when the financing proposals are forwarded; these contain the entire framework of indicators and conditions which are subsequently set out in full in the financing agreements. The Commission stipulates that the half-yearly reports should include, in their conclusion, an overall opinion on the public finance situation and the prospects for improvement.

38. The Court acknowledged that, with one exception, the Commission had identified all the weaknesses that the Court had found during its audit. The exception concerned 'commitment arrears' in Chad in connection with a programme that had been suspended by the Commission and was consequently no longer monitored in the same way.

The Government has agreed to adopt a number of corrective measures. The Commission will monitor the effect of these reforms.

39. The Court notes that the Commission's decisions were taken on the basis of precise knowledge of the situations (paragraph 31) and the essential developments expected (paragraph 38). The Commission will make sure that it provides more detailed arguments in support of its decisions.

40. In all the countries visited the Commission took action after the IMF and is operating in collaboration with the World Bank and, in most cases, with other donors too. Generally speaking, the donors (with the exception of the United States) are moving towards budget support. The question of visibility, the benefits of the aid, are among the factors taken into consideration.

42. The Commission has introduced an instrument for the systematic monitoring of public finance management; in the light of the lessons learned from the first wave of these reports, the Commission has proposed ways of improving it. These improvements will:

(a) take account of the situation described by the 'PEFA' indicators;

(b) include a systematic follow-up of the implementation of the institutional support programmes;

(c) include an analysis of the links between the weaknesses of the situation and the reforms and aid planned;

(d) include an overall conclusion by the delegation;

(e) require that the objective elements of these reports continue to be shared with the other donors;

(f) provide that the national authorities be involved as much as possible in the evaluation work;

(g) reduce the frequency of the reports to once a year as suggested by the Court, except in special circumstances requiring closer monitoring.

43. These reports are already based on the most recent evaluations.

44. The Measurement Framework has been tested, mainly by the Commission, and is in the process of finalisation. There is provision for changes to be made at the end of a one-year trial period. Some of the Court's suggestions have already been discussed with the other donors.

45. The definition of relevant performance indicators is a matter of ongoing concern for the Commission. This is one of the reasons why it carried out its retrospective assessment of its experience with variable tranches.

46. One of the lessons to be learned from this study is that, in order to be effective, indicators must be limited in number and cannot cover all aspects. They must focus on essentials. However, the Commission's monitoring is not confined only to these indicators, as can be seen from the structure of the monitoring report which the delegations are asked to produce.

47. The monitoring reports are still evolving. In their first reports the delegations described the current situation, and this could have created the impression that they were too 'static'. Subsequent reports focus more on dynamics. They have been used by the central departments, which are going to improve formal feedback to the delegations.

48. The incentive for a government to reform does not depend only on the suitability of the performance indicators. It is also linked to other factors such as the amount of aid, the overall conditionality of donors, the effectiveness of donor coordination, etc. The Commission negotiates the indicators with governments and tries to coordinate systematically with the other donors. In its view, it is normal that the type and number of public finance management indicators should vary according to circumstances in the different countries.

49. The Commission feels that it is essential to monitor budgetary allocation and implementation levels, especially in the health and education sectors, when it is providing budget aid. The fact that they are easy to measure is more an advantage than a drawback. Admittedly, they should be supplemented by a small number of indicators chosen to reflect the particular situation of individual countries.

50. Where necessary, details of the definition, calculation method and sources of information for each indicator must be provided.

51. The importance to be assigned to variable tranches and public finance performance indicators depends on a large number of factors: dependence on specific aid, whether or not the economic situation is fragile, situation of the health and education sectors, lessons drawn from earlier programmes, etc. In the case of the five countries observed by the Court, it is clear that the importance of the public finance indicators varied in proportion to the weakness of the systems (ranging from 59 % of the programme in Zambia to 7 % in Ethiopia).

52. Coordination with other donors, both at head office level and at local level, has always been one of the Commission's central concerns.

53. This coordination was developed within the context of the PEFA programme, initiated by the Commission and the World Bank, but also under the Strategic Partnership with Africa (SPA) and the OECD-DAC.

54. At local level, as the Court points out, coordination is quite good. While formal structures are certainly needed when a large number of partners are providing aid (Mozambique), they are not necessarily required when fewer partners are involved. The Commission has taken the lead in a number of areas (for example, by requiring that performance indicators be followed up) and has often initiated action in the form of donor groups. In other areas, it respects the distribution of roles between different donors (follow-up of the macroeconomic situation and revenue by the IMF, for example).

55. Admittedly, it is sometimes difficult, including for beneficiary countries and the IMF, to have a precise picture of the financing of aid by other donors.

56. If the reforms are to succeed, all those concerned must assume ownership of them.

58. The Commission is well aware of the importance of the role played by national parliaments and the need to promote and strengthen this role. However, its ability to intervene in this area should not be overestimated since the distribution and balance of powers between parliament and the government is a matter which is directly related to the sovereignty of the beneficiary State. It should therefore be approached only with the greatest caution and with due regard for the independence of the various institutions of the beneficiary State and for the Cotonou Agreement.

59. The situation regarding SAIs also varies a great deal from country to country. Whenever possible, though, the Commission generally tries to include useful information obtained from the SAIs.

60. Box 7 gives an example of the, sometimes difficult, dialogue which the Commission has developed in Mozambique with a SAI. In this case, the Administrative Court reminded the donors that it was an autonomous institution.

61. The Commission has on several occasions supported the SAIs and provided them with institutional support. A draft strategy paper has been sent to the delegations.

62. The possibility of allowing the Commission to approach parliaments and the SAIs should be examined on a case-by-case basis, with caution and in the light of the Cotonou Agreement. This is a very sensitive area which touches on national sovereignty and must be approached with due regard for the national rules on the distribution and balance of powers between institutions.

63. A balance must be found between the human resources responsible for monitoring and control and those who play an active part in policy dialogue and between those who monitor public finance and those who follow up social indicators or the macroeconomic context.

65. The Commission is aware that the targets it has set itself are ambitious given the human resources at its disposal. It would point out that increasing its tasks, as recommended in the report, would be likely to accentuate this discrepancy.

66. The Commission is in the process of developing checklists of the type suggested by the Court.

67. The Commission will continue its efforts in the field of training.

68. Exchanges between delegations will be encouraged on the basis of best practice.

69. See the Commission's reply to paragraph 38.

70. The Commission agrees with the Court that, in line with objectives, substantial progress in public finance management has been noted in the countries that have received budget aid. This provides confirmation for the Commission of its choices. Improving budget management has an impact on all government resources and not on Community funding. These improvements must be consolidated and continued, which argues in favour of continuing this work.

71. It should be noted that it is mainly under the impetus of the budget aid programmes that a comprehensive reform of public finance is properly on the agenda. In such a context, the fact that the Court of Auditors has noted 'reasonably positive partial interim results', is an achievement for which budget aid can take some of the credit.

72. Every financing agreement sets out in detail the conditions and results expected (measured by indicators) and constitutes a binding legal contract between the beneficiary State and the Commission. The Commission's reactions correspond to a risk management which it feels to be appropriate. Thus, in one of the five cases observed by the Court, the Commission suspended its aid. In the others it adjusted the amount of its support in accordance with movements in performance indicators which do not relate only to public finance but also to social services provided to the poorest populations, women and children.

73. At the end or, if appropriate, in the course of each programme, funding which has not been disbursed because the conditions have not been met or because the results have not been achieved is decommitted and repaid to the National Indicative Programme (NIP). However, this non-use of funding is, as a rule, authorised during the mid-term review or the final review, which, if necessary, allows the NIP amount to be reduced. The incentive effect of variable tranches is therefore unaffected.

74. The conditionalities and the weighting of the respective tranches and indicators are reviewed for each new programme, as can be seen from the review of aid carried out recently by the Commission.

CONCLUSIONS AND RECOMMENDATIONS

76. The Court observed that the Commission had defined a *methodological framework* which was a significant improvement on the previous situation (paragraph 23). It felt that this framework could be made clearer and more comprehensive on some points (paragraphs 25 and 26). In particular the cohesion and logical relationship of the programmes could be highlighted (paragraph 30). The updates to the methodological framework will be consolidated in a new version of the guide on which the departments are currently working and which will include an update of the monitoring reports (paragraph 42).

77. The Court noted that the methodological framework had been *implemented* in a reasonably satisfactory manner and that the performance indicators were being improved. Some aspects could still be made clearer or more comprehensive. The Commission points out that a balance must be sought between the various components of budget aid: attention to the question of the social sectors in particular must remain a priority. Budget aid will continue to tackle one of the main potential sources of corruption, viz. weaknesses in public finance management.

The delegations' reports should become more dynamic.

79. Coordination is a priority for the Commission, whether between head offices or at local level, particularly as regards the implementation of the PEFA Measurement Framework. In the field of budget aid, the Commission is active in all coordination forums.

80. The Court's audit accepts that the information on which the financing decisions were based, and subsequently the information in the follow-up documents, *gives a true view of the situation*.

81. The Commission notes that the Court does not question its interpretation of Article 61(2) of the Cotonou Agreement. The selective nature of Commission support, which is the result of this interpretation based on rigorous diagnosis and the beneficiary State's desire for reform, makes it possible to contain and to manage the risk mentioned by the Court.

82. The Commission will continue to improve the way in which the programmes are presented, highlighting internal cohesion while maintaining a reasonable balance between the different components of a programme (which is not limited to the question of public finance) and taking care to respect the balance between monitoring and control, on the one hand, and more active interventions with governments and other donors on the other, and taking into account the cost and expected benefit of more detailed information.

83. There are a number of indications that the management of public finance is improving in a great many countries benefiting from budget aid. On the question of risk, defined in the Commission's working paper 'Outline of risks linked to external assistance' as 'anything that may stand in the way of achieving the objectives', the Commission considers that risk should always be viewed 'in relation with the ultimate objectives to be achieved'.

84. The updating of the Methodological Guide is under way. The Commission was waiting for the Court's recommendations so that it could include those it considered apposite. The instructions will stress the need to make clear the cohesion of measures. The Commission notes that the Court has not questioned its choices and the cohesion of its actions. The fight against corruption, especially where it affects the use of public funds, is and will continue to be central to the programmes. A number of proposals for improving the monitoring report will be taken into account by the Commission. The Commission expresses reservations regarding revenue, not as regards the intrinsic importance of this problem but in terms of the value added the Commission can bring to the analysis of this area, which is very well covered by the IMF.

85. It is expected that the next guide will help to provide a more formalised demonstration, on a case-by-case basis, of compliance with Article 61(2) of the Cotonou Agreement.

86. The Commission will endeavour to use results-based performance indicators that offer the best possible incentive, even though it is always difficult to measure the real incentive effect.

87. The Commission is already doing all it can, and indeed has made it a priority, to complete the Measurement Framework for public financial management performance which is being developed within the PEFA and which it instigated. However, this also depends on the position of the other donors. There comes a time when a joint approach can be developed only if those concerned agree to compromise.

88. For many years, the Commission has been trying to promote coordination at local level and it has initiated a large number of joint frameworks of donors providing budget aid. The model advocated by the Commission would leave each donor free to make its own decisions.

89. Parliaments and the SAIs have an essential role to play. However, the Commission's ability to approach these institutions must be examined with caution and with due regard for national sovereignty and the national rules governing the distribution and the balance of powers between the institutions. It should also be studied from the point of view of the Cotonou Agreement.