

## I

*(Information)*

## COURT OF AUDITORS

## SPECIAL REPORT No 5/2001

**on counterpart funds from structural adjustment support earmarked for budget aid (seventh and eighth EDFs), together with the Commission's replies***(pursuant to Article 248(4), second subparagraph, EC)**(2001/C 257/01)*

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**ABBREVIATIONS USED**

ACP	African, Caribbean and Pacific States signatory to the Lomé Convention
EDF	European Development Fund
ESAF	Enhanced structural adjustment facility
FCFA	CFA franc
HIPC	Heavily indebted poor countries
IMF	International Monetary Fund
PRGF	Poverty-reduction and growth facility
PRSP	Poverty-reduction strategy paper
SCR	Common Service for External Relations
Stabex	System for the stabilisation of export earnings, provided for by the Lomé Convention
Sysmin	System of aid for mining products
TOFE	Table of government financial transactions
WAEMU	West African economic and monetary union

*References used*

COM(2000) 58 final	Communication from the Commission to the Council and to the European Parliament of 4 February 2000 on Community support for economic reform programmes and structural adjustment — Review and prospects
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**SUMMARY**

I. The Court examined the Commission's monitoring of the use of the counterpart funds from EDF support for structural adjustment in ACP States, but did not examine the structural adjustment programmes per se. The audit mainly considered 23 Financing Agreements concluded with eight ACP States between 1994 and 1999. Most of the support took the form of direct aid to beneficiary countries' budgets and was subject to the national implementing and control procedures applicable to public expenditure in the ACP States, not the EDF procedures.

II. The observations concerning the Commission's management are about the extent of budget expenditure targeting, the provision of funds, the use of technical assistance and auditing and the administrative organisation of the Commission departments. Some of the weaknesses that were noted in these different areas confirm the importance for the Commission of monitoring more closely the quality of public finance management in beneficiary countries, the volume and regularity of the social sector expenditure and the refocusing of programmes, in coordination with all the parties concerned, in order to achieve effective poverty reduction in the beneficiary countries.

III. Control of the expenditure targeted by EDF support was affected by the Commission's wishing to support balances of payments and priority sectors, and social sectors in particular, at one and the same time by re-financing expenditure. The controls were not always effective, because the data on the actual implementation of budgets were, in some cases, non-existent or inaccurate. Technical assistance was underused. Monitoring the quality and regularity of expenditure is the key to improving social services, but it was slow. From 1998 onwards the Commission's programme audit organisation improved. The irregularities that were uncovered did not result in funds being repaid to the EDF, but in several cases further aid was suspended pending corrective action.

IV. Given the weaknesses in the national implementation and control procedures for public expenditure, it is unrealistic to think that in the priority sectors the beneficiary States' expenditure will always be effected regularly and will have a real impact on the level and quality of social services. The reforms that have been undertaken by these countries in the area of public finance management are recent and will only be fully effective in the longer term. The reality of this was confirmed by the audits that have been undertaken by the Commission from 1998 onwards. The budgetary authority must be aware of the inherent risks of the approach that has been adopted, must insist that the risks be evaluated through audits of public expenditure and should endeavour to reduce the extent of them gradually by encouraging effective implementation of reforms in the ACP States and, in particular, by means of concerted action by all the donors together.

V. In order to improve control over the implementation of support and ensure that it develops in line with the new guidelines from the budgetary authority, the Commission should:

- (a) base its programmes on a strategy and a plan for the reform of public finance management and on intensive coordination between all the parties concerned;
- (b) draw up clear guidelines so that its departments are better able to assess progress in the management of public finance in each of the countries concerned and to carry out a qualitative appraisal of the expenditure, otherwise there is a risk that programme objectives might not be achieved;
- (c) lay down procedures for monitoring and control of each programme, before the Financing Agreements are concluded;
- (d) effect a better distribution between its own departments of responsibility for monitoring general macro-economic and institutional support, on the one hand, and, on the other, responsibility for appraising the operation of the social sectors;
- (e) in coordination with the IMF, improve the predictability of annual budget support, irrespective of the source of the funding;
- (f) within the framework of multilateral approaches integrate its sectoral support into the budgets of the beneficiary countries wherever possible.

## INTRODUCTION

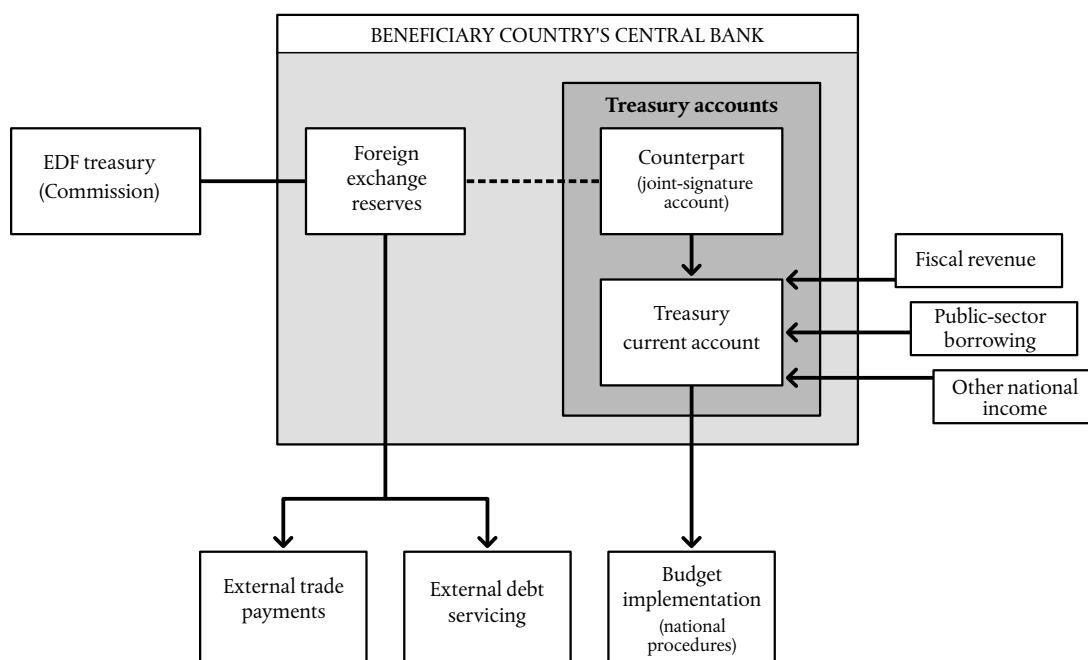
**Counterpart funds from structural adjustment support**

1. At the beginning of the 1980s many ACP States had substantial balance of payments and budget deficits, which they financed by recourse to external debts on a scale that was often excessive compared with their growth and revenue prospects. In order to counteract these difficulties the countries in question, under the aegis of the Bretton Woods institutions <sup>(1)</sup>, embarked on structural adjustment programmes consisting of a set of macroeconomic measures that aimed to restore economic equilibrium and reduce their financial deficits, both domestic (budget) and external (balance of payments). The European Community joined this process, with the Fourth Lomé Convention <sup>(2)</sup>, Articles 243 to 250 of which introduced a structural adjustment support facility. In consequence the Commission had, by the end of 2000, disbursed 2 320 million euro to 42 ACP States by way of this new Instrument, in order to support the reforms agreed between the beneficiary countries and the Bretton Woods institutions. These payments represented 22 % of the total payments from the seventh and eighth EDFs (see *Annex I*).

2. The EDF contributions are paid, in euro, into an account opened by the beneficiary government, usually with its central bank. The counterpart of these contributions is a deposit for the equivalent amount in national currency in a bank account, with two signatories <sup>(3)</sup>, with the same bank. The national currency amounts improve the government's financial position with the issuing institution by that amount and can be used to finance the beneficiary country's public-sector spending (see *Table 1*). The funds provided by means of EDF structural adjustment support have taken the form of:

- (a) balance-of-payments support, contributing to the economic and financial equilibrium of each country within the framework coordinated by the IMF;
- (b) support for the budgets of the beneficiary countries, giving priority to the social sectors. In actual fact, structural adjustment programmes usually entail a rescaling of public expenditure, which may be reflected in a reduction in social services for the poorest segments of the population.

Table 1

**Mechanism for mobilising EDF structural adjustment support**

<sup>(1)</sup> International Monetary Fund (IMF) and World Bank.

<sup>(2)</sup> The Fourth Lomé Convention was signed on 15 December 1989 with a duration of 10 years (from March 1990 to March 2000), together with a five-year Financial Protocol corresponding to the seventh EDF; it was revised on 4 November 1995, together with a second five-year Financial Protocol corresponding to the eighth EDF.

<sup>(3)</sup> Joint signatures of the Commission Delegate and the national authorising officer.

3. The EDF aid arrangements are subject to a joint management system put in place under the Lomé Conventions. Each structural adjustment support programme is the subject of a financing agreement between the Commission and the national authorising officer for the ACP State in question. In most of the beneficiary countries the financing agreements are supplemented by protocols of agreement which lay down conditions and procedures for using the counterpart funds.

4. The Commission neither authorises nor accounts for the use of the counterpart funds and they do not appear in its accounts. However, by insisting that the funds are deposited in a joint-signature account and that the financing agreements and protocols specify the conditions under which they may be used, the Commission has tried to ensure that the counterpart funds contribute to the development and good governance objectives pursued by the European Union.

5. Since the beginning of the seventh EDF the Commission has actively participated in consultations between fund providers and has adapted its support to the changing constraints in ACP States. In so doing it has switched from import aid to more general budget aid, placing the emphasis on the results of administrative reforms and on evaluation of the actual poverty situation. The terms 'import programme' and 'counterpart funds' ought to have been abandoned, since they have helped to sustain a certain amount of confusion about the reality of budget aid operations. In 1999, the main fund providers decided that, in return for aid, beneficiary countries should draw up and introduce poverty-reduction strategy papers (PRSP). This applies to IMF and World Bank loans, debt relief under the heavily indebted poor countries (HIPC) initiative, and European Community budget aid subsidies. When it replaced the enhanced structural adjustment facility (ESAF) with the poverty-reduction and growth facility (PRGF), the IMF made poverty reduction an objective and a criterion for evaluating the success of its programmes. The main guidelines presented by the Commission and the Council over this period are shown in *Annex II*.

### **The Court audit**

6. The audit was a follow-up to the European Parliament discharge resolution for the financial year 1998 <sup>(1)</sup>, with the objective of assessing the Commission's supervision, not of the structural adjustment programmes as such, but of the use of the counterpart funds resulting from EDF structural adjustment

support to ACP States. The appraisal was mainly based on examination of a sample of 23 Financing Agreements concluded with eight beneficiary countries between 1994 and 1999 for an amount which, at the end of 2000, represented 23 % of the structural adjustment support from the seventh and eighth EDFs (see *Annex III*). For these programmes, the audits at Commission headquarters were supplemented by site visits to the Delegations and to the national authorities responsible for the use of the funds.

7. This report shows that many of the observations that were published on the subject of counterpart funds between 1990 and 1996 in various annual reports and special reports of the Court (see *Annex IV*) are still relevant, despite the advances that have been made by the Commission in organising the follow-up to them.

8. This report is concerned only with the counterpart funds generated by EDF structural adjustment support. Other EDF financial instruments may also work towards the same objectives and take the form of budget aid <sup>(2)</sup>. The Stabex <sup>(3)</sup> and Sysmin Instruments, in particular, gave rise under the seventh and eighth EDFs to payments that amounted to 2 043 million euro as of the end of 2000. Food aid <sup>(4)</sup> and the dues paid through the Community budget under fisheries agreements are also sources of funds for the budgets of some ACP States.

## **PROGRAMME DESIGN**

### ***Scope of expenditure targeting***

9. The aim of targeting was to encourage satisfactory execution of the public expenditure that was considered to be a priority area for the ACP States, the most important being budget expenditure for social sectors <sup>(5)</sup>. In some cases it was also possible for the disbursement conditions contained in the Financing Agreements to make a contribution to the satisfactory execution of public expenditure. In Benin, for all the programmes examined, the conditions in question referred to the real level of budget implementation rather than budget allocation forecasts. On the other hand, in two of the countries reviewed (Senegal and Zambia) the Financing Agreements did not contain any quantified objectives for budget implementation.

<sup>(1)</sup> Resolution of the European Parliament containing its comments accompanying the European Parliament Decision giving discharge to the Commission in respect of the sixth, seventh and eighth EDFs for the financial year 1998 (OJ L 234, 16.9.2000). In recital D of the Resolution Parliament said that the use of counterpart funds suffered at times from inadequate management, poor supervision and insufficient evaluation.

<sup>(2)</sup> Article 226(c) of the Fourth Lomé Convention.

<sup>(3)</sup> See COM(2000) 58 final, section 2.1.1.

<sup>(4)</sup> See COM(2000) 58 final, section 2.1.4.1.

<sup>(5)</sup> See (COM)2000 58 final, section 2.1.3.2.

10. In half the countries examined the Financing Agreements and Protocols of Agreement concluded between the national authorising officer and the Commission Delegate detailed the support targets by means of a list of specific expenditure items selected from the social sector expenditure. In practice this targeting of specific expenditure items allowed the Commission to check how far the expenditure had been effected in the priority sectors and to see how expenditure was handled by the beneficiary country, but it also enabled it to confine its examination of supporting documents and the execution of selected expenditure items to an amount equivalent to the Community financing.

11. In all the countries where the EDF provides structural adjustment support, the IMF exercises surveillance over public finance in general. In 1996 the World Bank <sup>(1)</sup> observed that, given the fungibility of all government funds, it was more important for the Bank, in the context of structural adjustment loans, to look at the foreign exchange reserves and budget management as a whole, rather than concerning itself with the detailed application of its aid. At the time of the seventh EDF, fund providers in general were still only moderately interested in the qualitative aspects of public expenditure, which was why, starting with the audits of counterpart funds undertaken from 1995 onwards, the Commission gradually began to seek assurance as to the regularity and relevance of public expenditure by beneficiary countries in the sectors targeted by counterpart funds. However, it often confined itself to identifying expenditure to the amount of the Community finance, despite the fungibility of the budget support provided. In 2000, the Commission recognised the limited effectiveness of targeting, as well as its perverse effects, in certain cases, on the procedures and deadlines for budget implementation <sup>(2)</sup>, but it has still to define its approach to controlling expenditure, by seeking joint action with other donors.

### **Choice of target expenditure**

12. The choice of target expenditure was not just dictated by the desire to achieve a particular impact on social sectors: it is possible to achieve an impact by means other than disbursement conditions in financing agreements. In some cases it was the will to provide a rapid input of resources to the budget that prevailed, whilst in other cases the priority was to make it easier subsequently to provide administrative and accounting justification for the use of funds (see Box 1).

<sup>(1)</sup> World Bank Operation Memorandum 'Simplifying disbursements under structural and sectoral adjustment loans', 8 February 1996.

<sup>(2)</sup> See COM(2000) 58 final, sections 2.1.3.2 and 2.3.4.3.

#### Box 1

##### **Expenditure targeted**

1. *In Malawi, the programmes financed 98 % of the Ministry of Health's administrative expenditure (excluding salaries). Without this support the level of expenditure would have remained low.*
2. *In Benin, the effect of refinancing past expenditure, in the health sector especially, was to encourage the authorities to effect expenditure, at the same time providing a rapid input of additional resources to the national budget.*
3. *In Burkina Faso, the ease with which expenditure could be identified was one of the criteria that determined the choice of target, especially in the case of centrally administered expenditure, whilst in the health sector the budget headings that were targeted were not always directly linked to the priority accorded to the decentralised structures that were providing health services for the population.*
4. *In Senegal, it was mainly the expenditure with a strong chance of being executed regularly that was selected as targets in the health sector. On the other hand, the support for decentralised expenditure proved difficult to monitor.*

13. In many countries the IMF considers that the question of domestic arrears is crucial, because of its repercussions on the country's financial situation, as well as that of the private sector, and the banking sector in particular. Funding the arrears helps to redress the financial situation. It also makes it possible to free up resources quickly and can be equated with general budget support. There is, however, a risk that by taking over the residual results of past bad management or unauthorised expenditure, donors will take the responsibility away from the authorities and endorse the practices that gave rise to the arrears. Moreover, providing the finance to clear arrears constitutes action to improve public finance only if it is part of effective reforms that will prevent their resurgence. Whereas measures were being adopted in Benin, this condition was not satisfied when the Commission took over the responsibility for arrears in Tanzania and Zambia.

14. In Ghana, Zambia and Côte d'Ivoire, treasury bonds, or simply the financial costs which they generate, were redeemed <sup>(3)</sup>. This type of use, too, can be equated with rapid, general budget assistance, but does not have any direct impact on sectoral reforms and protecting the operation of social sectors.

15. The Lomé Convention provides that the counterpart funds may also be used as part of EDF project financing. Since it is difficult to reconcile these provisions with budgetary discipline when projects are implemented out of public funds but are not entered in the national budget, the Commission has gradually stopped targeting extra-budgetary projects. Until 1998, however, such allocations were being adopted in three of the countries

<sup>(3)</sup> See Box 5, paragraph 1.

reviewed (Ghana, Malawi and Tanzania). In Tanzania, there was no provision for these allocations in the Financing Agreement, but they were justified by the risks inherent in the poor quality of the public expenditure management.

16. The Commission communication of February 2000 gives very few figures concerning the nature of the target expenditure <sup>(1)</sup>. In particular, there is no mention of the fact that, according to the Commission's estimates, taking over the arrears absorbed about 7 % of the support from the seventh EDF.

## CONTROLLING PROGRAMME EXECUTION

### Support timetable

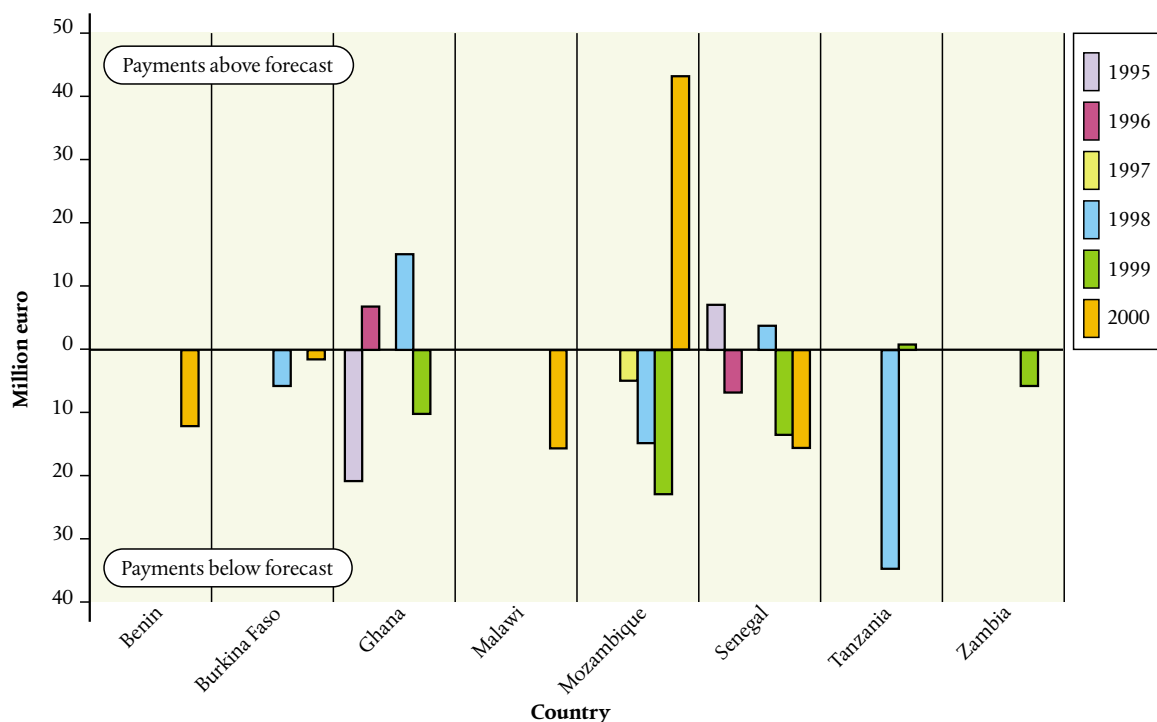
17. The Commission divided the structural adjustment support among the eligible countries for two-year periods. As the Commission did not think it possible to obtain reliable budget deficit statistics for the various countries <sup>(2)</sup>, the link between these

allocations and real financial needs is tenuous and is only one of the criteria for allocating resources. In the case of Senegal in 1998, whereas the Commission had provided the EDF Committee with justification for the Community support on the grounds of immediate financial need, at the end of 2000, FCFA 7 000 Mio (10,7 million euro) remained unutilised in the counterpart funds account and the authorities appeared to be in no hurry to use it <sup>(3)</sup>.

18. Table 2 shows that the calendar followed by the Commission in making support available to the beneficiary countries differed markedly from the intentions expressed in the financing proposals submitted to the EDF Committee. The time differences can be explained by the inherent delays of the EDF decisional procedures and the time required for ACP States to meet the disbursement conditions imposed by the Financing Agreements, with a total suspension of support if those conditions were not met. Under the prevailing system beneficiary countries could not be certain of financial support until just before it was actually disbursed by the Commission staff, often at the end of the financial year and after the countries in question had drawn up the budget for the financial year for which the support was programmed.

Table 2

### Differences between actual and expected payments for budget years 1995 to 2000 for the 23 programmes examined



Source: Commission decisions and accounts.

<sup>(1)</sup> COM(2000) 58 final, section 2.1.3.2.

<sup>(2)</sup> Information note to the EDF Committee dated 22 June 2000.

<sup>(3)</sup> Similarly, at the end of 2000, 29 million euro paid under Stabex, mainly from 1996 to 1998, remained unused in bank accounts in Europe.

19. After the foreign exchange had actually been disbursed by the Commission, in three of the eight countries examined (Malawi, Mozambique and Zambia), there were delays in the creation of the counterpart funds by the central bank. After that the transfer of funds to the general treasury accounts took place at varying rates. Due to these variations in the timetabling, the already tenuous relationship between the support granted and the treasury needs for particular budget years was stretched still further. This situation does not make it any easier for beneficiary countries to meet their foreign and domestic payment deadlines, nor does it help them avoid a build-up of payment arrears (see Box 2).

## Box 2

**Shifts in the support timetable**

1. In Malawi, a payment of 16 million euro scheduled for July 2000 was disbursed by the Commission at the end of December 2000, after several reminders from the Delegation to Commission headquarters. For its part, the central bank was late in paying funds into the counterpart funds account for the previous payment. The World Bank has estimated that the financial cost to Malawi of payment delays by all fund providers is around 11 million US dollars per year <sup>(1)</sup>.
2. In Zambia, the counterpart funds were paid into the joint-signature account six months after a payment of 20,6 million euro under the fourth structural adjustment programme.
3. In Ghana, it was not possible to establish a correlation between the annual volume of counterpart funds released from the joint-signature account and the amounts in foreign exchange decided by the Commission as support for the budget years in question.

20. There is no generally agreed practice among the IMF and the beneficiary countries as regards the procedures and timetable for incorporating Community financial support into the national accounts. Depending on the country or period, the support is (or is not) included in the calculation of the government's net position with its central bank. Similarly, it may be taken into account before the budget deficit estimates are established or, conversely, as a source of funding for the deficit. Such accounting procedures and delays do not make it easier to incorporate the support in the estimated budget revenue <sup>(2)</sup>, nor do they facilitate compliance with public accounting standards <sup>(3)</sup> and the coordination of assistance, that the Commission wishes.

<sup>(1)</sup> Report 'Administrative procedures for macroeconomic assistance to Malawi', table 'Cost of delays in macroeconomic aid and inflows 1996 to 1998'.

<sup>(2)</sup> Note to the Member States concerning convertibility and direct budget support, 3 February 1997.

<sup>(3)</sup> For example, the WAEMU guidelines for compiling the table of government financial transactions.

**Controls on the constitution of counterpart funds**

21. In several of the Commission Delegations checks on bank statements and the conversion rates applied were insufficient. None of the 23 Financing Agreements examined contained detailed information about determining the exchange rates to be used to calculate the national currency equivalents of payments made in European currency by the Commission. The Protocols of Agreement subsequently dealt with this point, but did not apply uniform rules (see Box 3).

## Box 3

**Controls on the constitution of counterpart funds**

1. In four countries (Malawi, Mozambique, Tanzania and Zambia), the central banks used unfavourable rates, thereby reducing the amount transferred to the exchequer.
2. In Mozambique, the exchange rate applied by the central bank in order to constitute the counterpart funds was 3 % below the most favourable rate. Furthermore an additional 1 % was levied by way of handling charges. According to the Court's estimates, the margin thus obtained by the central bank was four million euro.
3. In Mozambique and Senegal, the Delegations did not have any bank statements that could be used to check that the counterpart funds had been set up correctly. In Mozambique, in addition, the counterpart funds were not set up as a joint-signature account and the constitution of the counterpart funds corresponding to the 8 million euro paid under the first import programme (1992) could not be confirmed <sup>(4)</sup>.

**Use of technical assistance**

22. Technical assistance is one of the three forms of structural adjustment support provided for in Article 247 of the Fourth Lomé Convention. Article 20(e) of the Internal Agreement for the seventh and eighth EDFs defined its role only in relation to the monitoring of import programmes. This was the Commission's main concern in 1990, but it should have been adapted for the eighth EDF in 1995, in view of the emphasis placed on budget support. The Commission's operations manual, which was updated in July 1998, states that technical assistance may be employed to supervise and direct the operational side of programme implementation and to monitor budget implementation (programming, execution, control), but it does not contain any details about the timetabling or substance of these activities. The Financing Agreements rarely provided more detail and left the definition of needs and activities for the Protocols of Agreement concluded on the spot and for the remits technical assistants.

<sup>(4)</sup> As regards the difficulties experienced in connection with the central bank in Mozambique, see also paragraph 4.52 of Special Report No 2/94 on the import programmes carried out under the sixth EDF (OJ C 97, 6.4.1994).

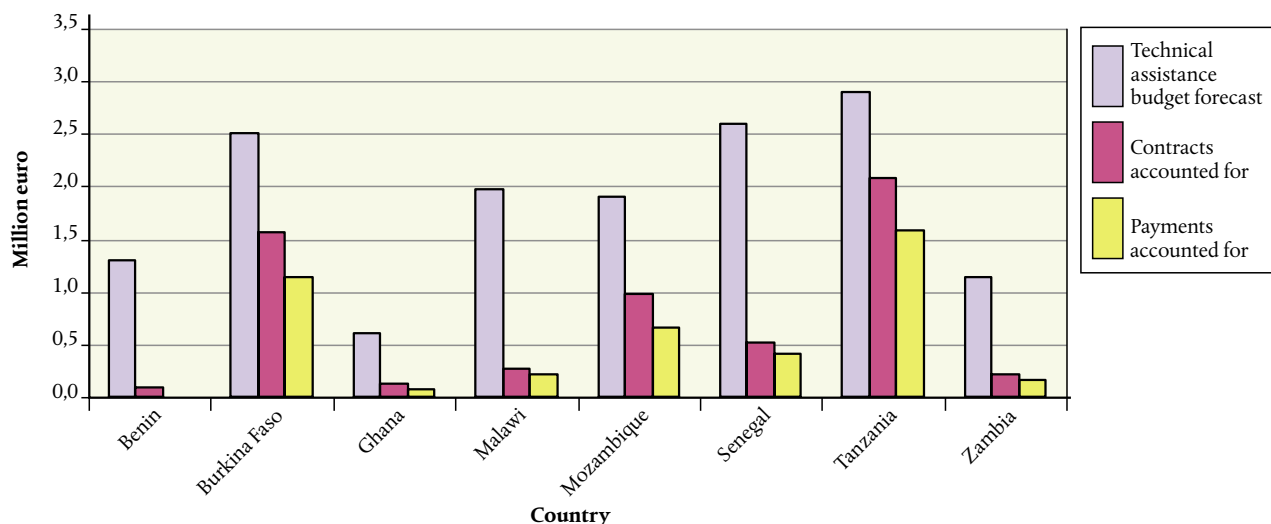


23. Table 3 gives an overview of the budgets allocated for technical assistance and their implementation for the programmes examined. These budgets were underutilised and often late in terms of the timetable for releasing the counterpart funds, to such an extent that only 31 % of the total finance provided had been subject to payments as of the end of 2000. With the exception of Benin, it was not possible to cite local conditions as the explanation for

the limited use of technical assistance and an objective reason for dispensing with it. The cumbersome nature of the Commission's centralised procedures for recruiting technical assistance and, in some cases, the reluctance of the national authorities, slowed down the release of the resources earmarked for these essential support functions.

Table 3

#### Implementation of the technical assistance provided for in the financing agreements examined



Source: Financing agreements and EDF accounts at 31 December 2000, according to the breakdown in Annex III.

24. In the eight countries examined the technical assistance personnel following the progress of operations in the target sectors were sometimes already working in place on other social-sector programmes, or even in budgetary and financial areas. This indirect monitoring did little for the transparency of the objectives pursued or the work carried out, which focused more on quantitative analysis of budgets than on the regularity and impact of the expenditure. Some technical assistance did make it possible for the Commission to monitor programme execution, but it was only indirectly that it had any operational advantages for the beneficiary administrations (Senegal). The division between expatriate assistance and local assistance was not based on any generalised policy. Amidst all this diversity some measures did have an impact (Burkina Faso, Tanzania), but the cases where tasks were badly defined and resources inappropriately mobilised were not always resolved and, on balance, there were very marked variations in the use of technical assistance.

25. In Benin, Ghana and Malawi, the finance for technical assistance was taken from the counterpart funds up until 1999 <sup>(1)</sup>, especially as regards the audits and evaluations provided for in the programmes. In such cases the activities are not recorded in the

Commission's management systems, which have no provision for analytically monitoring the technical assistance employed. As with EDF direct-financing, mission statements and contracts are negotiated on the beneficiary country's initiative. Commission control over these activities is much weaker than for the contracts concluded at central services level from other resources, especially as regards the actual content of the works, the harmonisation of methods and the time required to put them in place.

#### Auditing

26. The Financing Agreements make provision for financial audits to be carried out at the instigation of the Commission or the national authorities. Table 4 provides an overview, for the programmes under consideration, of the audits carried out and the follow-up to them. In half the countries concerned the audits covered all the programmes. In Zambia there were no audits, but the reasons for this exception were not clear. In only two countries (Benin and Burkina Faso) were the audits annual audits that covered all the support for one budget year, rather than a number of financial years receiving support from one, or even several, programmes. It was found that annual audits made a more timely contribution to programme-monitoring. They intermesh with the budgetary arrangements and reinforce the national public finance control systems.

<sup>(1)</sup> The Financing Agreements concluded in 1999 broke with this practice and provided for an audit and evaluation budget separate from that for budget aid.

Table 4

## Position at 31 December 2000 as regards audits of use of counterpart funds for the programmes examined

	Benin	Burkina Faso	Ghana	Malawi	Mozambique	Senegal	Tanzania	Zambia
Audit periodicity and coverage								
Annual audits	Yes	Yes	No <sup>(4)</sup>	No	No	No	No	None
Audit of all counterpart funds	Yes	Yes	Yes	<sup>(3)</sup>	No	No	Yes	None
Examine level of expenditure	Yes	Yes	Yes	Yes	Yes	Yes	Yes	None
Examine 'quality' of expenditure	From 1999	From 1999	From 2000 <sup>(2)</sup>	<sup>(3)</sup>	No	From 2000	From 2000 <sup>(2)</sup>	None
Follow-up of established irregularities								
Specific corrective action	Yes	Yes	Yes	<sup>(3)</sup>	No	<sup>(1)</sup>	Yes	None
Signature of protocol of agreement	No	Yes	Yes	<sup>(3)</sup>	No	<sup>(1)</sup>	Yes	None
Agreement on total ineligible expenditure (Mio EUR)	No	3,7	10,2	<sup>(3)</sup>	No	<sup>(1)</sup>	1	None
Reconstitution of counterpart funds	No	Yes	Yes	<sup>(3)</sup>	No	<sup>(1)</sup>	Yes	None
Repaid to EDF treasury	No	No	No	<sup>(3)</sup>	No	<sup>(1)</sup>	No	None

<sup>(1)</sup> Negotiations in progress.

<sup>(2)</sup> Financial audit by SCR in 2000.

<sup>(3)</sup> Audit performed end 2000 — Final report in preparation.

<sup>(4)</sup> In some cases the follow-up reports cover several years.

Source: Commission files.

27. Even where the controls on which the audits focused were similar, their terms of reference and the resources devoted to them varied significantly from one country to another. The disparity of the situations is not mirrored by any pragmatic policy of performing audits according to a reasoned evaluation of the conditions prevailing in each of the countries concerned. As in the case of technical assistance, a general framework outlining the objectives, defining the checks to be carried out and the scope of them and describing the auditing strategy would have facilitated the programming of resources by serving as a benchmark for all the countries.

28. Until 1998 the audits financed by the programmes were mainly concerned with the constitution of the counterpart funds, the eligibility of expenditure and the level of budget implementation. In some cases, however, the auditors devoted most of their work to understanding ill-defined expenditure systems, reconstructing accounts and producing quantitative overviews, without being able subsequently to examine the reliability of the accounts or the execution and regularity of the transactions, so that the reports proved to be inconclusive.

29. Following the irregularities established in Côte d'Ivoire in 1998 <sup>(1)</sup>, the Commission had a better idea of the risks associated with its approach. As of 1999, the financial audits in several countries were reinforced with checks that focused more on the nature of expenditure, the reliability of the accounts and the soundness of the management and control systems (see Box 4).

<sup>(1)</sup> Ineligible expenditure amounting to 27,4 million euro.

## Box 4

## Results of audits financed by the EDF

1. In Benin, the audit of health expenditure for 1998 revealed anticipations of the service rendered, poor inventory control and shortcomings in connection with tendering. In addition to verifying the reality of the arrears, the audit of arrears that was performed in 2000 also considered the plan of action proposed by the Government for preventing a recurrence of the situation.
2. In Burkina Faso, the auditors noted a number of irregularities in 1998 then, in 1999, stated that the accounts did not give a true view of the level of expenditure. In April 2000, an extended audit confirmed the weaknesses affecting the accounting systems and procurement procedures, highlighted fresh anomalies, questioned the administration and financial management of a public-sector institution and evaluated the impact of the various anomalies found in the financial years 1997 to 1999.
3. In Ghana, an extended financial audit of budget years 1996 to 1999 was carried out by SCR in February 2000. Apart from establishing the ineligibility of around 25 % of the expenditure, the final report in April 2000 gave numerous accounts of the weaknesses of the operational side of public finance, and of the control systems and tendering procedures as well.
4. In Tanzania, an audit was carried out by SCR in 2000 in order to check the 1999 support for the plan to clear internal indebtedness. Apart from the absence of supporting documents for 4 % of payments, the report highlighted the inefficiency of the internal control systems and the unreliability of the accounts.

30. In 1999 and 2000, SCR organised several financial audits in countries <sup>(2)</sup> where independent audit of the use of counterpart funds was felt to be a matter of priority. With a framework provided by a service specialising in financial

<sup>(2)</sup> Including Ghana and Tanzania, see Table 4 and Box 4.

audit, on the basis of carefully drafted terms of reference that were capable of yielding consistent, quantified results that would be comparable from one country to another, this initiative by SCR illustrates the advantages of a coordinated approach. Table 5 gives an overview of the main results of these audits. However, the

initiative did not cover all the countries. As regards the countries reviewed in October 2000, there were no audits of this type in Malawi, Mozambique or Zambia, countries where the risks of public finance management are similar to those identified in other countries.

Table 5

## Results of audits organised by SCR in 1999 and 2000

	Côte d'Ivoire	Chad	Cameroon	Guinea	Mauritania	Madagascar	Mali
Protocol of agreement signed	Yes	Yes	Yes	( <sup>1</sup> )	( <sup>1</sup> )	Yes	( <sup>1</sup> )
Agreement on ineligible expenditure total (Mio EUR)	27,4	1,0	5,5	( <sup>1</sup> )	( <sup>1</sup> )	0	( <sup>1</sup> )
CF reconstituted	Yes	Yes	Yes	( <sup>1</sup> )	( <sup>1</sup> )	No	( <sup>1</sup> )
Repaid to EDF treasury	No	No	No	( <sup>1</sup> )	( <sup>1</sup> )	No	( <sup>1</sup> )

(<sup>1</sup>) Negotiations in progress at 31 December 2000.

Source: SCR files.

31. The extent of the problems revealed by the financial audits from 1998 onwards persuaded the Commission to improve the follow-up to their results. In 2000, in three of the countries reviewed (Burkina Faso, Ghana and Tanzania), the implementation of programmes was suspended pending the signature of Protocols of Agreement on the treatment of the irregularities established. In Malawi and Mozambique the audits were not organised by Commission headquarters and were unsound, so that it was not possible to follow them up. In Benin the Commission simply took note of the Government's undertaking that it would in the future take steps to correct the weaknesses found during the audits.

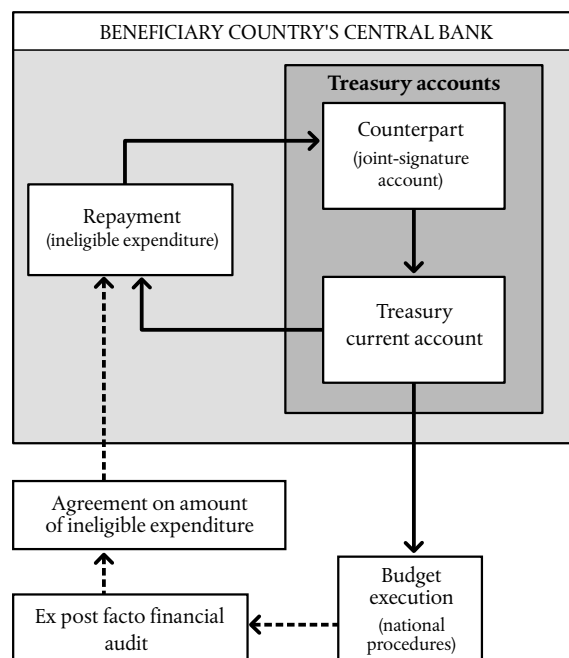
the audits led to the cancellation of the final instalments for programmes that had exceeded the completion deadlines (Côte d'Ivoire and Ghana), or to cuts in potential new allocations of foreign currency (Cameroon, Côte d'Ivoire, Guinea and Tanzania).

32. The Protocols of Agreement that followed the audits provided for the counterpart funds to be reconstituted by the beneficiary country to the amount of the ineligible expenditure. In principle this reconstitution entails for the Commission a right to review the execution of new expenditure. The Protocols of Agreement set out the measures which the governments agree to undertake in order to reinforce their public finance management, using part of the reconstituted counterpart funds for the purpose. These arrangements are a significant advance in the Commission's attention to tangible reform of the mechanisms for sound management of budget execution in beneficiary countries.

33. The Protocols of Agreement that stem from the audits make no provision for resources to be returned to the EDF. The reconstitution of counterpart funds is a transfer of funds between two government accounts for the equivalent of the ineligible expenditure (see Table 6). The impact of this is greater where the joint-signature account is omitted from the government's net position. Payments already made in support of the balance of payments, and those for servicing external debt in particular, thus become final. In Ghana a link was, however, established between the implementation of corrective measures and the provision of new foreign exchange aid by the Commission. In addition, there were several cases where suspensions of payment in connection with

Table 6

## Mechanism for repaying ineligible expenditure



34. The Commission has sometimes simply identified other eligible transactions to the amount of the Community finance as a way of correcting for ineligible expenditure that has been included in the accounts (see Box 5). This tendency first became apparent when the import programmes were being monitored

and in the preliminary audit of budget expenditure in certain countries, which turned into a 'hunt' for eligible invoices for amounts equivalent to the Community finance.

Box 5

**Substitution of qualifying expenditure for ineligible expenditure**

1. In Côte d'Ivoire, 18 000 million CFA francs (approximately 27,4 million euro) was returned to the counterpart fund account in January 2000, following audits in 1998 and 1999, bringing the total counterpart funds available to 28 800 million CFA francs <sup>(1)</sup>. The audits having shown that the practices in question would have to be improved before the Commission could again provide budget support for the Ministry of Health <sup>(2)</sup>, the funds were reallocated in June 2000 to refinancing treasury bonds that had already been redeemed (9 500 million CFA francs), to payment of arrears (5 000 million CFA francs), to support for the electoral process (6 000 million CFA francs), to implementation of corrective measures (4 300 million CFA francs), and to priority public health activities (3 000 million CFA francs). The Commission, in fact, gave preference to the objective of releasing the counterpart funds quickly in order to help the country meet foreign deadlines and relegated the social sector measures to a lower level of priority.

2. In Gabon, in order to allow programmes to continue in spite of the severity of the conclusions of the 1996 financial audit (irregularities, inadequate documentation, poor accounting management) the Commission accepted the principle of a new audit that sought to demonstrate that there had also been other, regular expenditure equivalent to the amount of the Community contribution. By doing this a new 'hunt' for invoices made it possible to turn a blind eye to the financing of ineligible transactions.

**The Commission's administrative organisation**

35. From 29 July 1989 to 18 June 2000, 40 internal notes on structural adjustment support were issued, most of them reviews or forecasts. Two precise sets of instructions on the procedures for monitoring counterpart funds date back to 14 March 1991. The instructions were not updated when the programme emphasis switched to budget aid and the quality of public finance management, so that they are still vague compared with the scope of the questions to be dealt with. It would have helped the Delegations to be consistent in their monitoring of different countries and managers had they been able to consult detailed information on the role of technical assistance, conditions for the release of counterpart funds to the general exchequer accounts, the line to be followed as regards arrears and the refinancing of past expenditure, respect for the annuality of the budget, and the nature and scope of the checks to be made by the various parties concerned. In most of the Financing Agreements this omission was remedied by a reference to subsequent Protocols of Agreement (see paragraph 10), which in many cases continued to be terse or irrelevant.

36. The Commission central services responsible for the design and monitoring of support for structural adjustment programmes were afflicted by the lack of organisation in their file management. Although a files and archives plan has existed

since 1999, the application of it and the structure of files are left to the discretion of individual members of staff. This is not sound administrative practice and is particularly damaging to the continuity of programme management. Owing to the heavy workload, the amounts at stake, the small number of staff, and the high staff turnover, these departments should be able to rely on an information system that is rigorously maintained, complete and reliable.

37. The Delegations' minutes vary in form and quality and the only model document, which was drawn up in 1991, is limited in scope. Under these circumstances the headquarters services have not been able to monitor the situation as a whole, especially not by means of summary management information on programme implementation. In order to assess the results of seventh EDF support, the Commission had to call in a consultant to collect the basic information on programme implementation which it lacked.

38. Monitoring and appraising the use of the counterpart funds, interaction with aid from other fund providers and mastery of macroeconomic and sectoral policies are difficult and complex tasks which call for a variety of skills. Quality of public finance management and sectoral policies using performance indicators have widened and complicated the area to be monitored. The respective duties of the headquarters departments and the Delegations varied between countries and, at the level of individual countries, between periods, according to the capabilities and inclinations of the departments responsible. These contrasts are attributable to the lack of detail in the instructions (see paragraph 35), and also to the unstable ratio of resources to requirements. From 1999 onwards the Commission headquarters departments have produced breakdowns of their duties, activities and resource allocations <sup>(3)</sup>. As of the end of 2000, however, the Commission, in the context of its reform of external aid, had still not defined the human resources and skills required at headquarters and in the Delegations to monitor the use of budget aid, particularly as regards the overall qualitative appraisal of public finance management.

39. It is important for the department specialising in macroeconomic questions, which is currently responsible for structural adjustment support programmes, to examine balance-of-payments aid in consultation with the IMF, the Member States and forums such as the Club of Paris, but taking into account as well the evaluation of the individual circumstances of EDF support. It is, however, inappropriate for this department to be involved in assessing the operation of social sectors as well. Monitoring and auditing the use of support in these sectors call for other skills, which are already available in other Commission departments (see paragraphs 30 and 50). Responsibilities for setting and monitoring the performance indicators in these sectors still have to be defined as part of the establishment of the external aid department (EuropeAid).

<sup>(1)</sup> Not including 7 200 million CFA francs for Stabex 1993, also available for use since the end of 1997.

<sup>(2)</sup> Protocol of Agreement dated June 2000.

<sup>(3)</sup> 'Mission statements' 2000 and 2001.

## THE CHALLENGES OF BUDGET AID

### Public finance management

40. EDF budget support is mobilised according to the beneficiary country's own public expenditure procedures. It is subject to the same internal controls, and the same risks, as the expenditure that is financed from national income and differs in this respect from project aid, which is implemented according to the procedures imposed by individual fund providers. Many financing proposals evaded the question of the quality of public finance management. Only the macroeconomic aspects and questions concerning the structure and drawing up of the budget were covered. More attention was paid to sectoral budget allocations than to their implementation (see paragraph 9). Although the Commission started to provide budget aid on a large scale with the seventh EDF, it was not until 1998 that it began to carry out qualitative appraisals of public expenditure management in ACP States.

41. In most of the countries examined the reform of public finance initially focused on the framework for drawing up budgets and was beginning to have an impact on the quality of the programming. The place of the public sector in social policies and government's capacity to collect and analyse sectoral statistics have still not received sufficient attention. These aspects are essential for appraisal of the sectoral effects of budget finance, especially as the NGOs and religious organisations often provide a substantial proportion of the social services available to the population.

42. Reforming the chain of expenditure and accounting was only tackled at the second stage. It was, however, in these areas that the various audits revealed the weaknesses that caused most concern as regards the proper use of budget aid. In general there were substantial delays in the forwarding of the accounts showing the implementation of the budget and they were insufficiently audited. The shortcomings in expenditure procedures were fairly similar from one country to another. Compliance with the national rules on budget annuality was jeopardised by disbursement delays and there was frequent use of exceptional procedures, so that payments were not always correctly authorised or accounted for and arrears began to accumulate. Imperfect mastery of procurement procedures led to excessive costs, because contracts were not put out to tender. Budget allocations were poorly mobilised as regards the more remote and less central levels. Administrative discipline (documentary evidence in support of expenditure, archives) was poor. The consolidation and the reliability of the accounts were affected by the lack of harmonised accounting procedures and by incomplete or late end-of-year adjustments.

43. In a number of the countries under review the recent reforms must be welcomed as a very positive advance. Nevertheless they were still far from ensuring that there was a sound

institutional framework to limit the risk of anomalies in the management of public funds, and it was difficult to judge how long it would be before the reforms began to take effect (see Box 6).

#### Box 6

##### Public finance controls in beneficiary countries

1. In Benin, the rationalisation and computerisation of the expenditure chain was undertaken in 2000. Financial controls and internal audits have been introduced, but with insufficient resources. The first discharge bill (1998 budget) was tabled for debate by the National Assembly in 2000, but could not be discussed for procedural reasons. The national audit institution and the parliament still did not have the resources needed for them to play to a full part in the budgetary control process.

2. In Senegal, many of the reforms that have nevertheless been undertaken by other countries were still at the project stage (notably the modernisation and computerisation of the expenditure chain), to such an extent that the undertaking to implement the WAEMU guidelines by 2002 seemed rather unrealistic. As of October 2000 the discharge bills for financial years 1997 to 1999 had still not been adopted. The *Cour des Comptes* was set up at the beginning of 1999 but only 12 of the complement of 60 magistrates were in office.

3. In Burkina Faso, the expenditure flows have been computerised since 1996, but the end-of-year closure procedures were still unsatisfactory. The discharge bills for financial years 1995 to 1998 had been drafted. However, as of the end of October 2000, they had not been sent to the national audit institution nor tabled in the national assembly. The national audit institution was reformed in 2000, but the new institution was still not operational at the end of that year.

4. In Ghana, a major public finance reform project that was started in 1996 in partnership with, amongst others, the World Bank and the European Community and with United Kingdom and Canadian cooperation, has made little progress in the area of dealing with expenditure and drawing up accounts, so that the first results are not expected until 2002. In the meantime heavy decentralisation, combined with a sectoral approach that has been well coordinated among the fund providers, has made it possible for the Ministry of Health to improve the quality of its financial management alongside the more general reforms. A restructuring of the national audit institution (800 auditors) was undertaken in 2000. The consolidated national accounts for the 1998 financial year have been audited and the consolidated national accounts for 1999 have been prepared. In 2000 the Parliament reported on the implementation of the 1996 and 1997 budgets and severely criticised the handling of expenditure.

5. In Mozambique, a strategy for reforming the management of public expenditure was drawn up in 1997. In 2000 the first quarterly reports on the implementation of the budget were prepared by the Government, as were the annual accounts (the first since 1975) for the financial year 1998. The audit of these accounts was Delegated to the Administrative Court (which reported to Parliament in 2000 on the 1998 accounts). This court is also responsible for ex ante financial control of expenditure, but the effectiveness of the latter was limited.

44. Not until 1999, as an aid to its examination of new loan applications, did the World Bank begin to evaluate beneficiary countries' ability to account for the implementation of their national budgets<sup>(1)</sup>. The IMF, for its part, offered beneficiary countries a framework for evaluating budget transparency. Other bilateral donors have recently begun to audit public finances and the governments of the ACP States themselves are placing more importance on the reform of public finances. The Commission has begun to appraise the overall management of public

(1) Country financial accountability assessment.

finance in ACP States, but since the appraisal is derived from the Commission's own audit results, it does not cover all beneficiary countries. At the beginning of 2001, as a consequence of the recent awareness of the significance of this omission, reinforced by the results of audits carried out on the Commission's initiative, the latter, with the World Bank, began to consider introducing an enhanced form of cooperation, with joint objectives and pooled financial resources <sup>(1)</sup>, and coordinating it with the work of all the parties concerned.

### Volume of expenditure in social sectors

45. In three of the eight countries examined (Benin, Burkina Faso and Ghana), the impact of support on the social budgets situation was carefully monitored and documented by the Delegations. It is difficult to establish a chain of causality between increased expenditure in social sectors and EDF aid, but some examples illustrate the positive role of the Delegations in respecting budget implementation objectives in Benin and Ghana. In Burkina Faso the complexity of the monitoring machinery did not ensure that the funds were actually spent during the budget year (see Box 7). In the other countries the limitations of the monitoring that had been applied meant that it was not possible to discern any relationship between the support provided and the budget input to the social sectors.

#### Box 7

##### Quantitative monitoring of expenditure by the Delegations

1. In Benin, the Delegation drew up a comparison for each budget year between the rate of health sector expenditure and the objectives that appeared in the financing Agreements. The correspondence between the Delegation and the Ministry of Health showed that in 1999 the Commission's determination not to release the counterpart funds until the objectives had been achieved had a decisive effect on the Government's respect for its undertakings.
2. In Ghana, the Delegation intervened actively in 1999 in order to speed up the release of budget appropriations in favour of social ministries.
3. In Burkina Faso, despite an overall increase in the budgets allocated to social sectors, the complex system of adding amending clauses to the Protocols of Agreement masked the take-up problems, as well as the delays in implementing budgets. By failing to compel respect for the budget timetable the system helped to institutionalise an excessive number of derogations to the length of the budget year, in the social sectors in particular, contrary to the principles of sound public financial management. In order to mop up 2 300 million CFA francs that remained in the accounts under the heading of support for the 1998 budget, the Delegation, in May 1999, proposed using an accounting device which would allocate the residue retrospectively to other 1998 budget headings where implementation had been satisfactory. The headquarters departments, quite rightly, opposed this and in November 1999 the residue was allocated to the 1999 budget.

46. The Delegations usually monitored the mobilisation of budget appropriations through the government's central accounts, but it was only in 1999 that the Commission began to pay attention to the question of whether these accounts were reliable, when ex post facto audits brought this issue to light in two of the countries examined (Burkina Faso and Mozambique), showing that the accounts overstated the real execution of expenditure in the target sectors.

### Impact of expenditure on social sectors

47. Commission monitoring has recently taken account of the objectives of the Financing Agreements that aim to improve social services for the population. For example, out of the 23 Financing Agreements examined, only two, signed in 1999 (Benin and Burkina Faso), included conditions relating to the results obtained in the social sectors. Very few resources were devoted to on-site appraisals of the utility, effectiveness and impact of the expenditure. Under these circumstances the Commission cannot evaluate the impact of the budget support contributed under the seventh and eighth EDFs on the quality of social services.

48. Since 1996 <sup>(2)</sup> the use of summary management information has been recommended as a way of including measured results in the mechanisms for assessing and controlling expenditure. The pilot experiment that was carried out in Burkina Faso made it possible to steer the political dialogue away from intentions and towards results. It also highlighted <sup>(3)</sup> the main difficulties that have to be overcome in order to permit credible use of summary management information: tight definition, preset levels of achievement, existence and reliability of systems for measuring results and, lastly, agreement between the partners as regards the choice of indicators within the framework of poverty reduction strategy papers (PRSP).

49. The problems of regularity and good governance <sup>(4)</sup> brought to light by the financial audits have a direct impact on the quality of expenditure and the situation of vulnerable and disadvantaged members of society. The public spending reviews that are carried out in many countries still have too little regard for the quality of expenditure and are usually only carried out intermittently, so that they cannot alleviate the shortcomings of the internal control mechanisms applicable to public finance in beneficiary countries.

<sup>(2)</sup> Commission working paper on the reformulation of conditions, December 1996.

<sup>(3)</sup> Commission internal note of 22 June 2000.

<sup>(4)</sup> Relevance of and justification for expenditure, reality of the service performed, fair price, absence of favouritism and distortions of competition.

<sup>(1)</sup> 'Trust Fund for Public Expenditure'.

50. Although the Commission's sectoral adjustment support encouraged sectoral reforms, the latter were sometimes undertaken without any direct link to the structural support, even when the expenditure targeting related to the sector or sectors concerned. The extent of these reforms was such that in several countries they were accompanied by coordinated multilateral initiatives, particularly as part of a global approach. The Commission's structural adjustment support programmes have so far not tackled the problem of integrating budget aid into these initiatives (see Box 8).

Box 8

**Multilateral sectoral approaches**

1. A multilateral sectoral approach was started in the education sector in Mozambique in 1998. Not until the financing proposal for the 2001 programme of structural adjustment support, however, did the Commission tackle the question of promoting improved access to social services in the areas of health, education and water as part of a sectoral approach. It would be better if the tasks associated with such participation were clearly defined, so that the number of sectors supported was compatible with the Delegation's resources.

2. In Ghana, alongside structural adjustment support, the EDF participated with other fund providers in a global sectoral approach in the area of health. Part of it concerned budget aid to a fund monitored and serviced jointly by several fund providers. The advantages and main features of this approach are very relevant in the context of redirected EDF budget support, especially as regards the management of public finance, result indicators and control procedures. In the delicate area of quality of expenditure it has had a real impact on the relevance of the investments.

**Redirecting the monitoring and control of budget support**

51. In the first half of 2000, on the basis of the review and perspectives drawn up by the Commission <sup>(1)</sup>, the Council <sup>(2)</sup> advocated less-detailed allocation of funds (untargeted, direct budget aid) in the countries whose public finance management was satisfactory and recommended establishing a link between the effects of reforms and disbursements of aid in foreign exchange. The financing proposals submitted to the EDF Committee in the second half of 2000 for five of the countries examined (Benin, Burkina Faso, Mozambique, Senegal and Zambia) anticipate the progress made in the management of public finances. At the end of 2000 the Commission departments expected that, following an audit in Senegal, the implementing arrangements for that country would be modified, because of shortcomings that had been found in the execution of recent programmes.

<sup>(1)</sup> Commission communication on structural adjustment, COM(2000) 58 final of 4 February 2000.

<sup>(2)</sup> Resolution of 18 May 2000 on structural adjustment.

52. These financing proposals gave as justification for abandoning targeted expenditure the absence of cash-flow problems and the sufficiency of the budget implementation (quantitative aspects), rather than the soundness of the public finance management. Some of the proposals include elements of management quality appraisal, but there is no explanation of what the consequences of the appraisal might be in terms of programme procedures and the release of funds.

53. It is difficult to assess whether the conditions for effective use of the performance indicators adopted in the financing proposals might be met in the future (see paragraph 48). In the area of sound public finance management, the performance indicators are still primarily quantitative and take too little account of the weaknesses identified by the audits carried out in 1999 and 2000. In the case of Senegal the choice of performance indicators was still under discussion when the Financing Agreement was signed in October 2000.

54. The new programmes drawn up in the second half of 2000 comprise several instalments. In every case the first payment is to be disbursed in the light of IMF macroeconomic evaluations. One instalment, which in the case of Benin represents half of the programme total (but only one third in the case of Burkina Faso, Senegal and Zambia), will be disbursed in varying proportions, depending on the level reached by the performance indicators. The systematic disbursement of a minimal sum is intended to ensure that the beneficiaries plan their use of resources better (see paragraph 18), but the procedures for releasing further instalments often require further definition, in order to ensure that poor performance is actually taken into account.

55. Although the system of targeting that has been established for selecting individual 'eligible' expenditure items is to be abandoned because of its artificiality and low impact on the quality of public finance management in terms of reducing the administrative cost, the Commission cannot forgo the controls that are necessary for it to assess whether the Community finances entrusted to it are properly used (see paragraph 43). In addition to a general review (for which the outlines still have to be defined), the new programmes provide for audits of a volume of transactions equivalent to the volume of support provided. There is little sense in the link that has been established between the extent of the checks and the amount of support. With the retention of targeted checks there is the risk of a tendency to pick out eligible expenditure items to the amount of the Community finance in order to obtain assurance (see Box 9). A sample check in order to assess the regularity of the transactions as a whole, in one or more expenditure sectors, would be more appropriate.

## Box 9

**Justifying the eligibility of expenditure**

1. *In the latest programmes for Benin and Burkina Faso, the role of audit in justifying European aid by verifying amounts of priority budget expenditure equivalent to the support given and certifying the eligibility of the financed expenditure lacks clarity.*

2. *The financing proposal for Mozambique is the only one that reflects an overall audit approach. It is, however, far from clear whether the work of the external auditors is consistent with that of the national audit institution and under what conditions the Commission will rely on it in order to produce an independent appraisal.*

56. The Commission Communication of February 2000 did not go into the question of expenditure controls <sup>(1)</sup>. In the context of untargeted budget aid the necessary assurance can only be obtained by means of overall appraisal of public expenditure, but the most recent Financing Agreements (year 2000) do not give any indication of a general audit approach combining the work of national audit institutions, external auditors and technical assistance and, when possible, other budget aid providers. In the absence of a soundly based approach, the results of the 1999 and 2000 audits are still not sufficiently taken into account by the performance criteria for sound public finance management.

**CONCLUSIONS AND RECOMMENDATIONS****General appraisal**

57. In beneficiary countries counterpart funds are made available as part of the national public expenditure procedures and because of that and the inherent risks of those procedures it is unrealistic to think that the quantitative objectives being pursued in the priority sectors can be achieved without any hitches (see paragraphs 45 and 46), that expenditure will always be executed regularly (see paragraphs 26 to 34 and 40 to 43) and that it will always have a positive impact on the situation in the social sectors (see paragraphs 47 to 50).

58. The desire to provide balance of payments support and support for social sector budgets simultaneously has sometimes affected the decisional mechanisms (see paragraphs 11, 33, 39, 52 and 54). The controls on the counterpart funds have, in some cases, been reduced to formal administrative justification and ex post facto checks on expenditure (see paragraphs 10, 12, 34 and

55) with no direct relation to properly functioning, government-run, social services for the benefit of vulnerable and disadvantaged people (see paragraph 47).

59. The Commission's headquarters departments did not pay sufficient attention to certain aspects of overall supervision (see paragraphs 17 and 37) nor to the technical aspects of the use of programme funds (see paragraphs 21 and 22, 35 and 36, 40 and 46). The new guidelines, and especially the increased importance attached to strengthening the management and control of public finance (see paragraph 51), should improve the effectiveness of the mechanism, provided that the framework for monitoring reforms has been improved, by means of institutional support if necessary, and that the Commission deploys appropriate resources to ensure that implementation is consistent and coordinated with the main providers of funds (see paragraphs 22 to 25, 27, 30 and 35 to 39).

60. In-country monitoring of the EDF programmes is based on combined action by various parties: the Delegations, public administration in the beneficiary countries, national audit institutions, technical assistance, and external auditors. The roles of those concerned within the organisational structure have not been defined sufficiently. Monitoring, carried out by the Delegations chiefly at central administration level, is hampered by the unreliability of public accounts, particularly as regards decentralised expenditure (see paragraphs 20, 38 and 46). Technical assistance was not sufficiently exploited as support for action by the Delegations (see paragraphs 22 to 25). The audits financed under the programmes rarely highlighted the internal control weaknesses that affected the use of the counterpart funds (see paragraph 28). The financial audits subsequently ordered by the Commission proved to be much more effective (see paragraph 30). It is important for these audits to be retained, but there is no guarantee that there will be provision for this under the current reorganisation. Any ineligibility discovered did not result in funds being repaid to the EDF (see paragraph 33), but in several cases new programmes were suspended pending corrective action.

61. With the support of fund providers, a number of countries have undertaken wide-ranging reforms that aim gradually to improve the management of their public finances. The process will, inevitably, be slow, because it is very complex and addresses a variety of situations and the beneficiary governments' resources are limited. As of the end of 2000 it is not possible to expect that budget aid will immediately be released in accordance with the principles of sound financial management and under conditions that are always regular (see paragraphs 41 to 43). The budgetary authority must be aware of the inherent risks of the approach adopted and must try gradually to reduce the extent of it by encouraging effective implementation of reforms in the ACP States, especially through concerted action by the donor community.

<sup>(1)</sup> COM(2000) 58 final, section 2.3.4.3.



### **Recommendations on the organisation of monitoring**

62. Recommendation 1 — In order to remove the ambiguities from programmes and ensure that support changes to follow the new direction being taken by poverty reduction, clear guidelines should be laid down for use by Commission managers and national authorising officers. The linkage of the remits of the main parties involved in the chain of monitoring and control must receive close attention. In particular:

- (a) criteria for assessing the progress made in the management of public finances (see paragraph 52) should be laid down and should include monitoring the remedies applied to weaknesses and shortcomings highlighted by financial audits (see paragraphs 42 and 56);
- (b) procedures for reviewing expenditure in a context of untargeted budget support should be defined and should give the budgetary authority an indication of the extent to which the funds are being soundly managed. Financial audits should be an integral part of this mechanism and could take the form of a set of sectoral appraisals where necessary (see paragraphs 55 and 56). They should preferably be carried out annually and aligned on the budget years of the beneficiary countries (see paragraph 26);
- (c) the various possibilities for making use of reliable performance indicators in the social sectors, and their relation to budget expenditure (see paragraphs 41 and 48) should be defined;
- (d) technical assistance for beneficiary administrations should be clearly distinguished from the technical assistance that helps EDF authorising officers and the Commission Delegations to fulfil their obligations (see paragraphs 24 and 25);
- (e) the nature and level of the Delegations' own supervision of expenditure should be specified. Although they cannot be held responsible for the management errors of the national departments that execute national budgets (see paragraphs 40 and 42), the Delegations must be able to perform a qualitative appraisal of the expenditure in priority sectors (see paragraph 47), one of the ways being concerted action by fund providers.

63. Recommendation 2 — The principles and procedures for the monitoring and control of aid (see paragraph 62), which are defined in detail when the programmes are drawn up, should be included in the financing Agreements (see paragraph 35).

64. Recommendation 3 — As part of the reform of its external departments, the Commission should establish a clearer separation between the responsibilities of, on the one hand, the departments responsible for examining programmes, for the overall monitoring of macroeconomic support and for the reform of public finance in beneficiary countries and, on the other, the departments responsible for assessing the functioning of social sectors (see paragraph 39).

### **Recommendations on coordination**

65. Recommendation 4 — The Commission should, each year, according to a timetable that is compatible with the drawing-up of the beneficiary budgets and coordinated with that of the IMF, decide the amounts of money that are to be disbursed for the following year, for each country, notify the beneficiaries of the amounts, then check that they are included in public accounts in accordance with a clearly agreed scheme (see paragraphs 18 and 20).

66. Recommendation 5 — Increased coordination between all the parties concerned with the improvement of public finance management in general, and within the PRSP framework in particular, would allow fund providers and beneficiary countries to define the tangible weaknesses in public finances (see paragraph 42) and would facilitate the piloting and periodic evaluation of the remedies applied and the progress achieved (see paragraph 62(a) and (b)).

67. Recommendation 6 — Wherever possible, the Commission, in association with other fund providers, should take care that its sectoral support is incorporated into the budgets of beneficiary countries. This type of approach would facilitate the desired cooperation with the bodies responsible for auditing public finance in the beneficiary countries <sup>(1)</sup>, since concerted action is essential if the objectives of qualitative improvement of public expenditure are to be achieved (see paragraphs 50 and 56). Furthermore, participation in multilateral sectoral programmes would be a visible demonstration of the Commission's intention of concentrating its efforts on a smaller number of sectors and activities <sup>(2)</sup>.

<sup>(1)</sup> 1999 Annual Report, paragraphs 46 and 47 (OJ C 342, 1.12.2000).

<sup>(2)</sup> Declaration of the Council and of the Commission of 10 November 2000 on the European Community's development policy, section 12.

68. Recommendation 7 — In order to facilitate the introduction of the above recommendations, programmes should place increased reliance on:

(a) a strategy and an overall plan for reforming public finance management for each country, highlighting the progress achieved in public expenditure systems. This development should be assessed and documented as part of an ongoing process, in coordination with other fund providers, so that

the direction followed in decisions and new measures is taken in full knowledge of what is involved;

(b) an overall approach in the social sectors, including mechanisms for qualitative control of expenditure (impact and management), here too, in intensive coordination with the main fund providers in the countries concerned, and with Member States in particular.

This report was adopted by the Court of Auditors in Luxembourg at the Court meeting of 27 and 28 June 2001.

*For the Court of Auditors*

Jan O. KARLSSON

*President*

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## ANNEX I

**AMOUNTS ALLOCATED AND DISBURSED FOR STRUCTURAL ADJUSTMENT SUPPORT UNDER THE SEVENTH AND EIGHTH EDFS  
AS AT 31 DECEMBER 2000**

(Mio EUR)

	Commitments			Payments		
	a	b	c	d	e	f
	Total structural adjustment commitments	Total country commitments	% = a/b	Total structural adjustment payments	Total country payments	% = d/e
Benin	118	329	36 %	85	141	60 %
Burkina Faso	225	557	40 %	193	340	57 %
Burundi	12	210	6 %	4	78	5 %
Cameroon	94	594	16 %	75	409	18 %
Cape Verde	22	89	25 %	9	46	18 %
Comoros	7	51	13 %	7	39	17 %
Congo	14	49	29 %	9	24	36 %
Côte d'Ivoire	138	650	21 %	122	483	25 %
Djibouti	23	43	54 %	13	27	48 %
Dominica	2	57	4 %	2	44	5 %
Ethiopia	163	818	20 %	137	484	28 %
Gabon	20	124	16 %	16	63	25 %
Gambia	17	68	25 %	13	44	30 %
Ghana	177	466	38 %	128	235	55 %
Grenada	2	24	8 %	2	23	9 %
Guinea	57	426	13 %	56	232	24 %
Guinea-Bissau	27	113	24 %	13	51	26 %
Guyana	19	112	17 %	16	66	24 %
Haiti	55	263	21 %	49	157	31 %
Solomon Islands	4	120	4 %	2	70	3 %
Jamaica	32	283	11 %	24	133	18 %
Kenya	24	550	4 %	0	228	0 %
Lesotho	29	154	19 %	29	102	28 %
Madagascar	84	454	18 %	56	253	22 %
Malawi	145	509	28 %	112	299	37 %
Mali	164	524	31 %	140	282	50 %
Mauritania	44	296	15 %	44	175	25 %
Mozambique	207	589	35 %	140	348	40 %
Niger	127	360	35 %	86	201	43 %
Uganda	187	699	27 %	111	429	26 %
Papua New Guinea	37	238	16 %	27	172	15 %
Central African Republic	39	190	21 %	16	131	12 %
Dominican Republic	31	275	11 %	31	144	22 %
Rwanda	75	327	23 %	16	174	9 %
São Tomé and Príncipe	7	32	20 %	2	16	14 %
Senegal	117	453	26 %	77	257	30 %
Sierra Leone	63	221	29 %	28	87	32 %
Tanzania	191	668	29 %	155	387	40 %
Chad	81	327	25 %	49	143	34 %
Trinidad and Tobago	9	62	14 %	9	41	22 %
Zambia	222	678	33 %	156	388	40 %
Zimbabwe	60	295	20 %	60	199	30 %
Admin., Intra ACP, misc	8			4		
<b>Total</b>	<b>3 183</b>	<b>13 347</b>	<b>24 %</b>	<b>2 320</b>	<b>7 643</b>	<b>30 %</b>
<b>% of total for the seventh and eighth EDFs</b>	<b>17 %</b>			<b>22 %</b>		
<b>Total for the seventh and eighth EDFs</b>	<b>19 103</b>			<b>10 480</b>		

Source: EDF accounts as at 31 December 2000.

## ANNEX II

## MAIN GUIDELINE DOCUMENTS ISSUED BY THE COMMISSION AND THE COUNCIL

Date	Institution	Title and subject	Reference
14.3.1991	Commission	Note to headquarters departments and Delegations — principle for using counterpart funds (instruction note 1)	VIII/C/2 — 43872
14.3.1991	Commission	Procedures for setting up and financial monitoring of counterpart funds (Instruction note 2)	VIII/C/2 — 43872
27.5.1991	Council	Resolution on the use of counterpart funds generated by the various development assistance instruments	6379/91
4.12.1991	Commission	Communication from the Commission to the Council: Progress report on the Community's involvement in the structural adjustment process in the ACP States	SEC(91) 2320
4.5.1992	Council	Resolution on structural adjustment	6038/92
10.11.1992	Commission	Communication from Mr Marin. Community support for structural adjustment of the ACP States: lessons learned and perspectives	SEC(92) 2082
9.3.1993	Commission	Information note on the state of implementation of resources for structural adjustment support under Lomé IV	
27.10.1994	Commission	Communication from the Commission — Community support for structural adjustment in the ACP States: towards the consolidation and strengthening of a realistic and concerted approach	COM(94) 447
24.4.1995	Commission	Information note on the state of implementation of resources for structural adjustment support under Lomé IV	
1.6.1995	Council	Resolution on structural adjustment	7711/95
15.2.1996	Commission	Working paper: Facts for an assessment of structural adjustment support under the seventh EDF	VIII/257/96
20.5.1996	Council	Conclusions on the implementation of counterpart funds from Community support for structural adjustment in the ACP States	7329/96
14.1.1997	Commission	Note to the Member States on convertibility and direct budget support under Lomé IV	
22.1.1997	Commission	Note — Schedule for drawing up financing proposals for structural adjustment	
25.3.1997	Commission	Communication from the Commission: support for structural adjustment and debt relief in heavily indebted ACP States. A Community response to the HIPC debt initiative	COM(97) 129 FINAL
19.7.1998	Commission	Update of instructions. Provisional edition for some parties	VIII D(98) — 47796
9.1998	Commission	Working paper: facts for an assessment of structural adjustment support under the seventh EDF	External report
4.2.2000	Commission	Communication from the Commission to the Council and the European Parliament: Community support for economic reform programmes and structural adjustment: review and prospects	COM(2000) 58 FINAL
18.5.2000	Council	Resolution on economic reforms and structural adjustment in developing countries	8571/00

ANNEX III  
PROGRAMMES EXAMINED

(Mio EUR)

Country	EDF	Project	Instrument	Year of financing agreement	Programme	Type <sup>(1)</sup>	Total		of which: technical assistance			
							Committed	Paid	Budget forecast	Note	Contracts accounted for	Payments accounted for
BEN	7	56	PIN	1997	BEN/7200/003	A	10,0	10,0	0,3	( <sup>2</sup> )		
BEN	8	2 + 3	FAS	1998		B	20,1	20,1	0,5	( <sup>2</sup> )		
BEN	8	11	PIN	1999	BEN/7200/004	B	8,0	8,0	0,5		0,08	0
BEN	8	12 + 13	FAS				21,9	3,5				
<b>Subtotal Benin</b>							<b>60,0</b>	<b>41,6</b>	<b>1,3</b>		<b>0,1</b>	<b>0,0</b>
BK	7	64	FAS	1995	BK/7200/003	A	18,3	18,3	0,85		0,63	0,6
BK	7	65	PIN				11,7	11,6				
BK	7	99	PIN	1996	BK/7200/004	A	5,2	5,2	0		0	0
BK	7	100	FAS				1,2	1,2				
BK	7	127	FAS	1997	BK/7200/005	A	5,9	5,4	0,85		0,44	0,4
BK	7	128	PIN				5,0	5,0				
BK	8	3 + 5 + 6	FAS	1998		B	27,0	21,0	0		0	0
BK	8	18 + 19 + 20	FAS	1999	BK/7200/006	B	49,0	46,3	0,8		0,5	0,13
<b>Subtotal Burkina Faso</b>							<b>123,2</b>	<b>113,9</b>	<b>2,5</b>		<b>1,6</b>	<b>1,1</b>
GH	7	35	FAS	1995	GH/7200/004	A	17,0	17,0	0,1	( <sup>3</sup> )	0,04	0,03
GH	7	36	PIN				4,4	4,3				
GH	7	48	PIN	1997	GH/7200/005	A	15,0	14,9	0,1	( <sup>3</sup> )	0	0
GH	8	5	FAS	1999	GH/7200/006	B	21,4	10,6	0,4		0,08	0,04
<b>Subtotal Ghana</b>							<b>57,8</b>	<b>46,8</b>	<b>0,6</b>		<b>0,1</b>	<b>0,1</b>
MAI	7	97	FAS	1998	MAI/7200/003 (1997-1999)	A	12,0	12,0	0,7		0	0
MAI	7	99	PIN				5,0	5,0				
MAI	8	6	PIN	1998		B	13,5	13,5	0,7		0,26	0,21
MAI	8	7 + 8	FAS				8,5	7,8				
MAI	8	15	PIN	1999	MAI/7200/003 (1999-2001)	B	10,0	0,0	0,6		0,01	0,01
MAI	8	16 + 17	FAS				42,1	20,0				
<b>Subtotal Malawi</b>							<b>91,1</b>	<b>58,3</b>	<b>2,0</b>		<b>0,3</b>	<b>0,2</b>
MOZ	7	82	PIN	1997	MOZ/7200/001	A	15,0	15,0	0	( <sup>2</sup> )	0	0
MOZ	8	2	PIN	1998	MOZ/7200/002	A	15,0	15,0	1,9		0,98	0,66
MOZ	8	3 + 4	FAS				52,8	51,6				
<b>Subtotal Mozambique</b>							<b>82,8</b>	<b>81,6</b>	<b>1,9</b>		<b>1,0</b>	<b>0,7</b>
SE	7	74	FAS	1995	SE/7200/002	A	12,5	12,5	0,3		0,3	0,3
SE	7	75	PIN				11,6	11,6				
SE	8	4 + 5	FAS	1998	SE/7200/003	B	27,9	27,0	1		0,21	0,11
SE	8	16 + 17 + 18	FAS	1999	SE/7200/004	B	39,1	0,0	1,3		0	0
<b>Subtotal Senegal</b>							<b>91,1</b>	<b>51,0</b>	<b>2,6</b>		<b>0,5</b>	<b>0,4</b>
TA	7	62	PIN	1994	TA/7200/002	A	16,6	16,5	1,4	( <sup>4</sup> )	1,33	1,22
TA	7	63 + 78	FAS				18,4	18,4				
TA	8	2 + 3	FAS	1998	TA/7200/004	B	71,2	35,5	1,5		0,74	0,37
<b>Subtotal Tanzania</b>							<b>106,2</b>	<b>70,4</b>	<b>2,9</b>		<b>2,1</b>	<b>1,6</b>
ZA	7	71	FAS	1995	ZA/7200/004	A	13,7	13,7	0,05		0,11	0,1
ZA	7	72	PIN				3,1	3,1				
ZA	8	6 + 7	FAS	1999	ZA/7200/005	B	46,7	40,6	1,09		0,11	0,06
ZA	8	8	PIN				7,0	6,0				
<b>Subtotal Zambia</b>							<b>70,5</b>	<b>63,4</b>	<b>1,1</b>		<b>0,2</b>	<b>0,2</b>
Total examined							682,7	527,0	14,9		5,8	4,2
%							21 %	23 %				
Total structural adjustment support from the seventh and eighth EDFs.							3 183	2 320				

<sup>(1)</sup> A = import programme, B = budget aid.<sup>(2)</sup> To be financed with counterpart funds.<sup>(3)</sup> Does not include budget implementation audit to be financed with counterpart funds.<sup>(4)</sup> Budget not specified.

Source: EDF accounts at 31 December 2000.

## ANNEX IV

## MAIN COMMENTS MADE BY THE COURT IN THE PAST ON THE MONITORING OF COUNTERPART FUNDS

Annual/Special Reports	Extracts — Court observations	Extracts — Commission replies
Annual Report 1989 (OJ C 313, 12.12.1990) (repeated in Annual Report 1991)	13.45. ... the Court has been unable to get complete and reliable information regarding counterpart funds. Given the amounts involved the Court considers that the budget authority should receive, along with the EDF balance sheets, information in respect of each beneficiary country, regarding the establishment of the counterpart funds, their use, and the amounts remaining available at the end of the financial year.	13.45. It should be made clear that counterpart funds do not belong to the Commission in the same way as the aid money it dispenses. From the outset the countries receiving these funds have tended to consider that the money is now theirs and they do not have to account for the way in which it is used. The increasing amounts involved and the difficulty of keeping track of utilisation have prompted the Commission to tighten up the rules (joint management) regarding establishment and use of this money. There has been some resistance on the part of the recipients to the introduction of these new rules. Reflecting this, the information provided by the countries concerned has been sporadic and incomplete and the Commission has been unable so far to draw up a full statement of counterpart funds for inclusion in the annual balance sheets. The Commission departments concerned are currently devoting considerable attention to this problem, however, and will keep the budget authority and Court of Auditors informed.
Annual Report 1991 (OJ C 330, 15.12.1992)	17.111. It would be desirable that the existing manual of instructions be amended to address monitoring and reporting matters such as the aims, frequency, reporting and follow-up procedures of site visits by advisers, the financial management and administration of projects, and the different types of report to be submitted to central services. As part of this update of the manual, a review should be undertaken to evaluate the level of detail in monitoring that can be expected from Delegations with their present staff resources.	17.111. The Commission will take the Court's observations into account for a future update of the Manual of Instructions.
Annual Report 1994 (OJ C 303, 14.11.1995)	11.39. The fungible nature of budget resources has led most donors — including the Netherlands, Sweden and the United Kingdom — not to earmark closely the use to which their counterpart funds should be put. Their attention is instead focused on ensuring that the recipient government's budgetary policy as a whole is directed in an appropriate manner, and that particular sectoral policies are being pursued.  11.78. ... The Commission should... develop quantitative and qualitative targets for priority sectors or subsectors, in addition to any macroeconomic targets contained in the structural adjustment programme. The sectoral targets, which may include objectives for specific projects or programmes, should be incorporated into the financing Agreement, and form the prime focus of the monitoring exercise	No reply.  11.78. The Commission has always attached great importance to the integration of counterpart funds into budgets and budgetary analysis of their targeting. To this end, it has taken part in, or followed, the budgetary reviews conducted by the IMF and World Bank. A stepping-up of its involvement in the context of the appraisal of a new structural adjustment operation in Tunisia should lead to closer dialogue with the States concerned on priorities and public spending cuts. We must avoid, however, imposing a plethora of conditions that are disproportionate to the EU's financial contribution and liable to hold up the implementation of programmes as has happened in experiments carried out by the World Bank (stop and go).

Annual/Special Reports	Extracts — Court observations	Extracts — Commission replies
<p>Annual Report 1995 (OJ C 340, 12.11.1996)</p>	<p>12.14. The Commission gave a very broad interpretation to the provisions of the Convention relating to the seventh EDF by introducing a system less directly linked to the physical implementation of imports and, in practice, equivalent to global balance-of-payments assistance and support to the budget of the ACP States.</p> <p>12.20. ... marked differences occur, depending on the country, between Financing Agreements governing similar programmes, as well as in the implementation of these programmes, even though in terms of management of public funds or monetary systems there are no fundamental differences on first analysis</p>	<p>12.13 and 12.14. The Commission believes that it has been applying the Lomé Convention properly:</p> <ul style="list-style-type: none"> <li>(a) financing is not backdated for reasons of rapid disbursement, but because the availability of foreign currency is usually concentrated in time, whereas the timing of imports is geared to the needs of the economy rather than to disbursements;</li> <li>(b) Funds are very rarely paid in a single tranche;</li> <li>(c) The rules have been applied in accordance with the legislation in force, which provides for a case-by-case approach. This approach is specified in the financing proposals presented to the EDF Committee. Retroactive financing is a practice used by all the donors.</li> </ul> <p>The Court's report mainly focuses on the impact of the Commission's funding for the social sectors. It accords limited attention, however, to the impact of balance-of-payments support. This approach could cause readers to underestimate the role actually played by the Commission in structural adjustment, especially with regard to the liberalisation of foreign exchange markets, support for making currencies convertible, etc.</p> <p>12.20. In addition to the definition of the main axes for the implementation of Community structural adjustment support to ACP countries when the Lomé IV Convention became effective, a series of relevant documents has been presented detailing the modalities of structural adjustment support, policies on counterpart funds and public-spending reviews. Among the relevant documents we can cite:</p> <ul style="list-style-type: none"> <li>(1) Commission document on use of CPF (1991) and Commission Directive on modalities on constitution and financial follow-up of CPF (1991);</li> <li>(2) Council resolution on constitution and use of CPF (1991) and SPA guidelines on CPF (1991);</li> <li>(3) Council resolution on structural adjustment (1992);</li> <li>(4) Council resolution on structural adjustment (1995);</li> <li>(5) SPA guidance on public expenditure review process (1995).</li> </ul> <p>These documents present clearly the operational framework concerning the constitution, remuneration and use of CPF, earmarking, priorities for the social sectors, modalities of control and follow-up, etc.</p> <p>It is obvious that no precise directives were produced on other subjects since this would have worked against the principle of avoiding standardisation.</p> <p>While giving a precise framework for policy in the field of structural adjustment, these documents have certainly left room for manoeuvre in order to comply with the Lomé Convention request for adapting our modalities of intervention to the specific situation of each country in order to avoid standardisation of programmes. In particular, modalities of earmarking of CPF have to take into account sectoral policies and quality of budgetary processes as well as overall macroeconomic objectives.</p>

Annual/Special Reports	Extracts — Court observations	Extracts — Commission replies
<p>Special Report No 2/94 on the import programmes carried out under the sixth EDF (O) C 97, 6.4.1994)</p>	<p>12.60. Finally, budgetary assistance is of only limited value in countries where the budgetary procedures are shaky or where the implementation of the budget is slow, centralised and not very transparent, or where the control of expenditure is almost non-existent.</p> <p>12.61. [Sectoral targeting and global allocation] may be contemplated only in those countries where the procedures for effecting public expenditure are transparent.... the Commission should regularly assess the quality of these procedures and it must take a firm line if the ACP State goes back on its commitments.</p> <p>6.4. The central accounts of the EDF do not make it possible to monitor the import programmes immediately and the financial statements give no figures for the counterpart funds (5.25 and 5.26).</p> <p>6.21. In Ghana and in Zambia, untimely withdrawals from the counterpart funds by the authorities totalled approximately 11,2 Mio ECU (4.51).</p> <p>6.24. The structure of the Commission's central departments remains poorly suited to effective monitoring of the import programmes (5.12 and 5.13)</p>	<p>No reply.</p> <p>12.61. Though the revised Fourth Lomé Convention introduces the possibility of direct budget aid (i.e. without having to prove that imports have been made), the problem of whether targeting should be more or less specific remains the same. Methods depend very much on the quality of public finances in the country concerned. We do, however, share the Court's view on the attention to be given to the budget.</p> <p>Through its participation in public-spending reviews with the other donors and its own sectoral reviews (in the social sphere), the Commission is already very much involved in assessing the quality of public finances in terms both of the nature and efficiency of spending and of the budgetary process and procedures. This approach is currently employed on a country-by-country basis under the SPA donor group's new guidelines for the improvement of public finance, institution-building being the very foundation of the Commission's action.</p> <p>6.4. Local currency operations are the responsibility of the national authorities, even though the Commission is involved in their running. Information on the management of counterpart funds was given in the 1992 management accounts, and more detailed data will be provided in 1993 accounts (5.20, 5.25 and 5.26).</p> <p>6.21. Commission missions to Ghana and Zambia in 1993 regularised both the situations referred to by the Court, the amounts in question being entered in the country's budgetary spending and allocated to priority sectors selected jointly by the Commission and the recipient (4.51).</p> <p>6.24. The setting-up of the Structural Adjustment Unit has made it possible to establish an overall policy for the implementation of import programmes in the context of macroeconomic stabilisation policies and structural reforms and in compliance with the political priorities of the Council and the Commission, namely:</p> <ul style="list-style-type: none"> <li>— long-term development,</li> <li>— internalisation of programmes,</li> <li>— adjustment of the pace of reform to the needs of the country concerned,</li> <li>— the social and regional dimension to adjustment.</li> </ul> <p>The Structural Adjustment Unit has also been a means of establishing a dialogue with the IMF and the World Bank on structural adjustment and the general macroeconomic environment in which the ACP States find themselves.</p>



Annual/Special Reports	Extracts — Court observations	Extracts — Commission replies
	<p>6.25. The scope of the instructions given to the Delegations in 1990/1991 should be extended so that administrative audits may be more closely related to the risks which programmes run (5.19) and more details may be given about what sort of cooperation the Council intends to establish (2.9(e)) between the Commission and the representations of the Member States in the ACP States (5.20).</p> <p>6.26. The new instructions are proof that the Community's policy with regard to the counterpart funds has definitely been rationalised. However, the procedures for monitoring their implementation should be made more explicit, since it would be illusory to assume that 'reviews' and entries in the budget will on their own be enough to ensure that the counterpart funds will be used in priority sectors. In this regard, close cooperation between the various suppliers of funds would seem to be unavoidable (5.23).</p> <p>6.29. Because the actual execution of the programmes was in most cases located downstream of the disbursement of EDF funds, the legal framework, the financial systems and the operational structures of the Lomé Convention and the Commission turned out to be not very well adapted to control of either the importation procedures or the procedures for creating and utilising the counterpart funds. Given the difficulties it was confronted by, the Commission reacted fairly swiftly and, with effect from 1991 (the Council resolution on the counterpart funds), the management of the import programmes was gradually strengthened. Many of the decisions taken since then should already have had perceptible effects on the first waves of the Lomé IV import programmes; for example, there is now more systematic use of technical assistance, more precise instructions are sent to the Delegations, the objectives and the conditions of the Financing Agreements are framed less ambiguously and a unit for monitoring the counterpart funds has been created. However, the application of these measures is uneven and some of them amount to nothing more than a step in the right direction. For these reasons, it is important that the Commission should continue with its efforts to discipline the programmes, in particular in the area of instructions and resources given to the Delegations and in that of the impact studies required by the new integrated approach to the management of the programmes.</p>	<p>6.25 and 6.26. The creation of the Counterpart Funds Unit within the Directorate of Finance has made it easier to get to grips with the situation and problems on the ground and to draw up guidelines for the Delegations.</p> <p>No reply.</p>

Annual/Special Reports	Extracts — Court observations	Extracts — Commission replies
<p>Special Report No 2/95 concerning the Stabex fund in the context of the first Financial Protocol of the Fourth Lomé Convention (OJ C 167, 3.7.1995)</p>	<p>11.9. The changes made by the new Convention have introduced contradictions between some of its objectives.... Although the Convention does retain, in principle, the sectoral approach (6.2), the overall economic context cannot be ignored without the risk of inconsistencies with the structural adjustment policies applied elsewhere (6.4 and 6.5). Finally, the introduction of frameworks of mutual obligations brings with it long drafting (6.13 and 6.14) and implementation periods (7.3 and 7.4), which deprive the Stabex mechanism of its characteristics as a short-term, rapid-disbursement instrument (5.5 and 6.24).</p> <p>11.10. The Convention did not provide for the allocation of considerable amounts of Stabex funds to general programmes or sectoral import programmes (7.5). As a result, it did not provide a framework of management for the considerable amounts of counterpart funds that these programmes generate (7.3(c) and Annex 6). There was therefore nothing to stop the counterpart funds being allocated several times over to operations that were alien to the objectives of the Stabex system.</p> <p>11.12. The payments entered in the accounts by the EDF overstate the actual use that is made of the transfers by treating the payments made into intermediate bank accounts opened in the name of the beneficiary ACP States as final payments (3.4). Moreover, the Commission has no consolidated information available as to the use that is actually made of the transfers (7.1) or of the counterpart funds (7.3).</p> <p>11.13. The implementation of the frameworks of mutual obligations has given rise to a second level of management of EDF appropriations which is not subject to the control procedures prescribed by the Financial Regulation, whereas comparable operations (e.g. import programmes) financed through other instruments are subject to the Financial Regulation (5.2(a) and 9.4).</p>	<p>11.9. Where the transfer is large in relation to other economic factors (the country's budget of balance of payments, for instance) it inevitably has a macroeconomic impact that should not be overlooked. The uses to which the transfer is put should therefore at least be consistent with the country's general economic policy, and preferably actively second and further this policy. What applies at macroeconomic level is all the more true at sectoral level: transfers that are large in comparison with sector variables must be used in a way that is consistent with, and supportive of, sectoral policy.</p> <p>The importance of macroeconomic and sectoral consistency is not confined to Stabex transfers but is true of all forms of aid. It is particularly true in the case of countries where Stabex transfers are relatively substantial and are used in a fairly short span of time. This is not a 'contradiction' but a reality that has to be taken into account in implementing Stabex.</p> <p>And while it does take more time to negotiate FMOs and satisfy the conditions for their implementation than it does to use a transfer not subject to the same conditions, this is not a contradiction but a desire to find a balance between quick disbursement and the checks on their use demanded by the Member States. Despite the time taken to do this, Stabex funds are mobilised quite quickly compared with other quick-disbursing instruments of the Commission and other donors (see reply to points 6.4 to 6.6).</p> <p>11.10. The 'Principles, guidelines and rules for the use of Stabex transfers under Lomé IV' of 4 February 1991 referred to by the Court (see point 6.12) has a whole chapter devoted to the subject of generation of counterpart funds by import programmes. The Commission had foreseen that Stabex-funded import programmes under Lomé IV would generate large amounts of counterpart funds and that a degree of flexibility in applying the rules on the allocation of foreign exchange would be called for.</p> <p>11.12. Although the payment of Stabex transfers and the entry of these payments in the accounts are the last steps of the financial procedure, the departments in Brussels have established a number of measures to keep track of both the foreign exchange and counterpart funds. It is planned to strengthen and improve these measures still further.</p> <p>11.13. See reply to paragraph 5.2(a). 5.2(a) These funds are no longer EDF funds but belong to the ACP country concerned, the use to which they are to be put being stipulated in the FMO. The Commission therefore does not think one can talk about a second layer of EDF management.</p>

Annual/Special Reports	Extracts — Court observations	Extracts — Commission replies
	<p>11.14. The frameworks of mutual obligations have burdened the Commission Delegations with a considerable amount of preparatory and monitoring work for the support and reform programmes although their staff numbers have not been reassessed in the light of this extra work (5.2, 6.17 and 7.53).</p> <p>11.16. The decentralised mechanism for the preparation and the implementation of the frameworks of mutual obligation has experienced delays caused by the intervention of the central departments during the preparatory stages (6.15, 6.22 and 6.23) and has been affected by the contrasting positions adopted, which varied according to the country or the financial instrument, when questions such as the choice of operations to be financed (7.8, 7.13, 7.31, 7.38, 7.42 and 7.43) or observance of the conditions governing the release of funds (8.9 to 8.23) were concerned.</p> <p>11.17. Stabex funds have too often been orientated towards operations intended to clear up past errors rather than towards the making of investments in new sectors, instead of in sectors with no real prospects (6.2, 6.5 and 7.5). These debatable allocations of funds have been facilitated by the presence of counterpart funds accompanying the import programmes. These transfers have thus served to make up for the poor management by public bodies (7.26, 7.27(d), 7.29 to 7.33, 7.39 and 7.41), the debatable choice of monetary policy (7.28, 7.37 and 7.38) or faults of viability in the price support systems (7.42 to 7.49), most usually to the detriment of producers (2.8(d) and 6.2).</p>	<p>11.14. The Commission will ensure technical assistance is used where appropriate; it can easily be financed with Stabex resources, if need be. As to staffing levels, the Commission can only, as we said in the introduction, do the best it can with the resources available.</p> <p>11.16. Delays in drawing up FMOs usually arose because of discussions with the national authorities on the use of transfers and conditionality. Such discussions are only to be expected in the case of transfers of what are often substantial sums of money and they can take some time. Internal consultations within the Commission on how the FMOs were to be applied (especially as regards macroeconomic and sectoral consistency) were indeed needed at the beginning of the FMO implementation procedure but countries receiving large transfers (Côte d'Ivoire and Cameroon, for instance), where there was intensive debate on the best way of ensuring macroeconomic coherence, were also among the countries that were quickest in approving and implementing their FMOs. This internal debate did not, therefore, slow down the adoption of the FMOs; on the contrary, it paved the way for speedy implementation thanks to proper identification of the recipient country's priority needs.</p> <p>11.17. The Commission believes that Stabex funds have usually been used as required by the Lomé Convention</p>

## THE COMMISSION'S REPLIES

### SUMMARY

I. The study concerns one aspect of the assistance provided by the Commission for structural adjustment programmes: the monitoring of counterpart funds. The Court of Auditors did not look into the role of the Commission in such programmes, the use of conditionality, the impact of assistance on macroeconomic balances or on the structural and sectoral reforms central to such programmes.

Structural adjustment programmes, in which the Bretton Woods Institutions (BWI) play a major role under their international mandate, are complex. They are aimed at encouraging the beneficiary countries to carry out what are seen as essential reforms: macroeconomic reforms and structural reforms concerning public finances, privatisations, civil service reforms, etc. The support provided by the international community has always been conditional on adherence to a macroeconomic programme monitored primarily by the IMF and structural reforms guaranteed by the World Bank. Compliance with the programme's conditions enables the donors to provide balance-of-payments support with a direct impact on governments' budgets. The Commission has taken part in such programmes and sought to make sure that certain of its concerns were taken into account. In line with the Council's guidelines, these concerns include shielding priority sectors, especially the social sectors, and supporting reform in those sectors: the introduction of essential drugs policies, the re-targeting of budget spending on primary spending, the introduction of vaccination policies, etc. This concern has been reflected in Community support programmes by specific conditions and by the targeting of counterpart funds generated by assistance. These programmes have changed considerably in the past two years. These changes reflect both the lessons learned and the Lomé Convention's emphasis on a gradual approach that respects a country's efforts to implement difficult reforms that cannot be carried out all at once.

II. The Commission's approach has been consistent with the principles of the Lomé Convention: its concern has been to support reform programmes drawn up by governments (Article 244(a)) and backed by the donor community, and in particular the BWI. It has adhered to the principles laid down: respect for countries' priorities (244(e)), a realistic pace of reforms (244(g)), adaptation to needs (248(a)) and flexible implementation (247(4)).

Most of the programmes for which the Court of Auditors examined counterpart funds belong to what can be described as the first generation of economic reform programmes, which focused on priority reforms. The current trend in programmes owes much to the Commission's role in the international debate. The Commission has, in the past two years, applied an innovative approach based on indicators of budget performance and results, especially in the social sectors.

III. In these programmes the Commission's checks have focused mainly on compliance with the conditions determining the disbursement of aid.

While the other donors have confined themselves to providing aid for cash-flow, the Commission has sought, by targeting funds, to make sure that its aid promoted the execution of spending in priority sectors. The targeting of counterpart funds offers governments an incentive to execute priority spending and therefore to increase their volume, since the Community's money is paid to the treasury as it executes such spending. The government loses out if it fails to execute the targeted budget expenditure. Moreover, the supporting documents necessary for the disbursement of Community funds oblige the government to monitor budget execution.

As for technical assistance, it is provided to governments at their request, in accordance with the Lomé Convention. The support has fostered an approach whereby technical assistance can be rapidly provided to any government expressing the need. Changes have been made to make sure that unused sums are returned to the budget support.

IV. It is vital that the developing countries improve their management of public finances. This will obviously take time and will have to be done in stages: the donors will have to coordinate their activities and monitor the progress made by the beneficiary countries. Budget support allows this issue, which cannot be addressed by projects alone, to be raised.

Structural adjustment programmes have brought major reforms in the management of public finances. Audits by the Commission have shown that further developments are necessary. Of all the donors, only the Commission has monitored governments' budgets and insisted on corrective measures and repayments to the

central bank accounts requiring the signature of the Commission and the beneficiary country. In order to promote a concerted approach by the donors in this matter, the Commission and the World Bank have decided to set up a trust fund for designing tools for assessing public finances and measuring progress.

V. The Commission endorses the recommendations of the Court of Auditors, which in many cases reflect the guidelines followed in the programmes implemented over the past two years: increased coordination under the Poverty Reduction Strategy Papers, pursuit with the Bretton Woods Institutions of common instruments for assessing the quality of the management of public finances, increased importance of issues related to public finances, development of budget performance indicators and performance indicators in the social sectors. It will maintain the current approach to non-targeted programmes recommended by the Court of Auditors in point 55. It will foster the planning of aid with three-year programmes under the Cotonou Agreement. Last but not least, it is developing, as a complement to macroeconomic aid, sectoral approaches within the budget framework, as authorised by the Cotonou Agreement. It will continue to pursue a consistent approach based on its delegations and capacities in both the economic sphere and specific sectors, especially the social sectors. New instructions based on these developments and the implementation of the Cotonou Agreement are now being finalised by the Commission.

It undertakes to specify the monitoring arrangements in the financing agreements rather than in the protocols for the use of counterpart funds. These will reflect the proposals of the Court of Auditors, namely that the overall quality of public finances be assessed, as far as possible, with other donors and indicators specified for measuring the progress made. In addition to the Court of Auditors's recommendations, the Commission proposes to check that a sum matching its aid has been used to fund basic spending in the priority sectors.

## INTRODUCTION

### *Counterpart funds from structural adjustment support*

2. The description of the use of structural adjustment funds is not wholly consistent with the objectives laid down by the Lomé Convention. Structural adjustment support has primarily focused on macroeconomic reforms, an area in which the IMF is the main player, and structural reforms, in which the World Bank takes the lead, in accordance with their international mandate. The Commission has backed such reform programmes by means of an approach geared to developing specific aspects. It has from the

very outset drawn attention to the dangers of cutting public spending without protecting priority sectors, and in particular social sectors. It has endeavoured to make sure that structural reforms redirect budget spending towards the primary sectors (in particular basic health care and primary schools) or foster improvements in the policies pursued (e.g. essential drugs).

This support for sometimes difficult reforms is voiced in the conditions attached to the disbursement of tranches, an aspect outside the scope of the review of the Court of Auditors.

The report therefore concerns only one, Commission-specific aspect of structural adjustment support, namely the monitoring of the counterpart funds generated by the foreign exchange provided. The other donors, and in particular the Bretton Woods Institutions which offer soft loans, have simply transferred their aid to treasury departments or central banks with no particular monitoring.

4. The Commission's initial objective was to ensure that the support provided did actually help governments to protect priority spending.

5. Structural adjustment programmes have evolved in step with the progressive, realistically paced approach recommended by the Lomé Convention. The recent shift towards support for Poverty Reduction Strategy Papers (PRSPs) reflects the Commission's long-standing concerns: an increased emphasis on the results for the population, ownership of programmes by the countries concerned, increased attention to sound management of public finances.

This shift towards what can fairly be described as second-generation reforms reflects a change in priorities now that many of the most pressing cash-flow problems have been resolved and basic reforms carried out. Over the last two years the new approach has led the Commission gradually to review its support mechanisms. The Commission accepts the proposal of the Court of Auditors that the term 'counterpart funds' be abandoned in the context of budget aid.

## PROGRAMME DESIGN

### *Scope of expenditure targeting*

9. The targeting of budget aid supplements the conditions attached to programmes, which were not reviewed by the Court of Auditors. Targeting is in itself an incentive to governments to

execute the targeted spending, since the Community's money is paid to the joint-signature treasury account as such spending is executed. The government loses out if it fails to execute the budget. Moreover, the supporting documents required for disbursements oblige the government to monitor budget execution.

The conditions governing budget execution have therefore been invoked only where targeting itself has proved inadequate or where the Commission has switched to non-targeted aid.

11. The past two years in particular have seen the Commission switch to non-targeted aid while seeking to develop an overall approach to supervising spending with the other donors.

### ***Choice of target expenditure***

12. The choice of targeted expenditure has in most cases been dictated by an analysis of what were held to be the most vulnerable expenditure headings while seeking a rapid input of funds consistent with the instrument's purpose. Box 1 shows how the refinancing of expenditure in Benin sanctions past use of the budget. In very many cases this targeting has had beneficial effects: increasing the level of budget execution in social sectors in Benin (Box 7), increasing budget execution in Malawi (Box 1). Other effects include the implementation of essential drugs policies or the decentralisation of the supply of materials to Burkina Faso's schools. The impact on the social sectors is to a great extent achieved through conditionality.

13. The expenditure covered by Commission programmes is part of the stabilisation and economic reform programme; this is particularly the case of arrears. Targeting arrears is not general budget aid, it is very clearly targeted. There are many economic arguments (presented to the EDF Committee and forwarded to the Court of Auditors) for targeting such expenditure, which is audited before repayment. Adjustment support programmes are aimed at limiting arrears and are supervised by the IMF, an activity that the Commission does not intend to duplicate. The Commission considers the reform programmes steered by the IMF in the countries cited to be effective.

14. The financing of arrears or treasury bonds does not prevent the Commission from supervising sectoral reforms or making sure that social sectors are protected. This is done indirectly by relieving the financial burden on the government and through the conditions attached to the programme.

15. The Commission's position is to encourage the inclusion of all external aid in the budget (including project aid) and, it is true, to move away from project financing: in Ghana, for example, this aid has been decreasing, and other expenditure requested by the government but not included in the budget has been refused by the Commission.

16. February 2000's communication to the Council gives a sectoral breakdown of targeted expenditure showing, for example, that health, education and road maintenance (excluding arrears) have respectively accounted for 34 %, 27 % and 6 % of counterpart funds.

## **CONTROLLING PROGRAMME EXECUTION**

### ***Support timetable***

17. There are no international standards for budget deficits. Indeed, they have only recently been established at European Union level. The criteria used for budget aid are therefore based primarily on balance-of-payments financing needs. 'Need' is obviously a subjective concept, and we are still a long way off covering a country's needs. The concept of overfinancing does not exist: in the case of a very poor country like Senegal this would be tantamount to saying that it had too much money (something even the richest countries would deny).

19. There are several possible explanations for the differences between actual and expected payments, in particular difficulties in discussions between a country and the IMF ('off track' or suspended programmes). In the case of Ghana and Tanzania, for example, IMF programmes were suspended for about two years. It is no doubt possible to improve the predictability of budget support but this remains largely contingent on the outcome of the IMF's assessment. In other cases delays can be attributed to failure to comply with specific conditions. The shift to three-year programmes under the Cotonou Agreement will increase the predictability of aid for countries that perform well.

## Box 2

**Shifts in the support timetables**

1. In Malawi payment was made at the end of 2000 after a review of compliance with conditions. The analysis of compliance presented by the Government via the Delegation had been considered inadequate by the headquarters departments responsible.
2. In Zambia the Commission paid for a consultant to examine the issue raised by the Court of Auditors and carried out an audit in the country.
3. In Ghana the two-year interruption in the macroeconomic programme accounts for the discrepancy between the year of disbursement and the year of use of funds.

20. The Commission regrets that there is no international IMF standard for the incorporation of external budget aid.

**Controls on the constitution of counterpart funds**

21. In a country with a convertible currency there is only one exchange rate for official transactions (the interbank rate) recognised by the country's financial and monetary rules (that rate being used for BWI aid to the central bank). However, the Commission will see that it specifies the exchange rate to be used in future financing agreements.

## Box 3

**Controls on the constitution of counterpart funds**

1. The Commission believes it justified not to use preferential rates and to align itself on the formula used by the central bank for converting its foreign-exchange holdings (interbank rate).
2. In Mozambique the amount of the counterpart funds results from the formula applied by the central bank. The administrative costs highlighted by the Court of Auditors are no longer applied to direct budget aid to Mozambique.

**Use of technical assistance**

22. Under the Lomé Convention, technical assistance, including its terms of reference and the choice of consultants, is the responsibility of the national authorising officer: the Commission is therefore dependent on the government for the use made of it.

23. Recent programmes adopted by the Commission have tried to resolve the issue of technical assistance by according countries greater flexibility in the use of funds for capacity-building. In the event of such assistance not being used, these programmes provide for the resources concerned to be reincorporated into the budget support.

24. The Commission believes that it makes sense to use its various instruments in a coherent manner and to make use of any existing skills. Quite apart from the fact that it is not covered by the Lomé Convention, the breakdown between local and expatriate technical assistance depends on local skills and governments' choices.

25. In the case of technical assistance paid for using counterpart funds (Benin, Ghana, Malawi), contracts have always been closely supervised by the delegations, which have consulted headquarters whenever necessary.

**Auditing**

26. With regard to the audits carried out by the Commission, the Zambian audit began on 14 May this year. The delay was wholly due to a shortage of resources in the Commission's audit department.

29. It should be stressed that the Commission is the only donor to have conducted audits covering government budgets in the course of its budget support programmes. Box 4 confirms the impact and relevance of the Commission's audits.

30. The overall audit of budget support to Malawi took place in November last year; the audit of support for Zambia has just begun. Only Mozambique has yet to be audited. The implementation of these audits is constrained by the understaffing of the department concerned.

Response to table 5: The audit in Mauritania confirmed the ineligibility of certain expenditure already rejected by the Commission and therefore required neither a protocol of agreement nor the repayment of funds.

33. Where audits have revealed shortcomings in governments' budget management, the Commission has taken a number of measures: (1) repayment to the joint-signature account for counterpart funds. This repayment is, however, much more than a mere transfer between two government accounts, since the joint-signature account, which is generally held at the central bank, cannot be used by the government. These joint-signature accounts

are not usually included by the IMF in the government's net position and automatically limit the government's cash-flow. Where they are taken into account, they enable the government to borrow either from the banking sectors or the central bank. As for possible repayments to the EDF, this does not apply because counterpart funds are not EDF resources (see point 4) but own resources of the beneficiary country; (2) the drafting of an action plan to limit the risks of new shortcomings; (3) the identification of institutional support needs; (4) in many cases, the reduction or cancellation of programmes.

34. The acceptance of invoices eligible for European financing is quite above board as long as it is accompanied by broader measures to improve the quality of budgets (see also response to points 55 and 56).

Box 5

**Substitution of qualifying expenditure for ineligible expenditure**

1. In Côte d'Ivoire, of the planned allocations of repaid funds, only election support, the refinancing of treasury bonds and certain emergency health spending have actually been implemented, primarily owing to the suspension of cooperation with the country on political grounds. As for the concern to release funds quickly, this can only be explained in the context of the quite exceptional financial and institutional situation prevailing in the country in the period April-September last year.

2. In Gabon the acceptance of eligible invoices for European financing is quite above board: a wide-ranging audit of public finances and the government's internal arrears permitted major reforms, in agreement with the IMF. The support programmes of the BWI and the Commission were suspended pending the conclusion of the audits and signing of a new agreement with the IMF (October last year).

36. The Commission reiterates the commitment it gave in the 1998 discharge to set up an effective archiving system, something on which it is actively working. Indeed, a filing and monitoring system has been set up by the unit responsible for macroeconomic support.

37. Supervision by headquarters services has normally focused on monitoring the overall programme and compliance with programmes' conditions. Supervision of disbursements of counterpart funds according to the rules agreed in the protocols of agreement has been exercised by the delegations under the supervision of headquarters. The consultant recruited carried out an in-depth study, including qualitative judgments (based on a questionnaire sent to all the delegations concerned), something that officials could not have done in good time.

38. The shortage of human resources means that the Commission is constantly having to prioritise its activities. In any case, the issue of the resources needed to supervise the quality of public finances can only be resolved by an overall approach and a division of responsibilities involving the other donors.

39. The macroeconomic unit is not alone in monitoring the sectoral impact of aid (this is monitored by the delegations and by the units responsible for the sectors concerned: roads, agriculture, social sectors). In order, however, to separate, in macroeconomic programmes, the assessment of purely macroeconomic aspects from that of the effectiveness of the policies carried out to reduce poverty, recent Commission programmes distinguish purely macroeconomic tranches from variable tranches linked to performance indicators in the social sectors (a proposal that came out of the test on the reform of conditionality).

**The Commission's administrative organisation**

35. The instructions concerning counterpart funds were updated by a Commission communication and a Council resolution in 1996 and by a new DG VIII manual of procedures in 1998. It is, however, clear, in view of this Court of Auditors report and the guidelines it lays down and the implementation of the Cotonou Agreement, that new instructions are being drafted, especially concerning the abandonment of the term 'counterpart funds', the abandonment of targeting and the assessment of the quality of budget management.

**THE CHALLENGES OF BUDGET AID**

**Public finance management**

40. As the Court of Auditors notes in point 11, the IMF exercise supervision over the entirety of public finances. The Court of Auditors also noted the developments in the Commission's approach to audit (points 26 to 29). At present the shortcomings in the management of public finances, highlighted in particular by the Commission's audits, need to be assessed and monitored by means of a coordinated approach involving entire donor community, not just the Commission.



42. The description by the Court of Auditors of the challenges of budget management illustrates the scale of the problems encountered in the developing countries. The Commission's step-by-step approach is warranted and consistent with the Lomé Convention/Cotonou Agreement.

46. The computerised system set up by Burkina Faso to track expenditure is one of the best in Africa. As in many other countries, it requires further development to track devolved expenditure.

### ***Impact of expenditure on social sectors***

47. The Commission led the way in addressing the question of the assessment of the quality of public services, introducing performance indicators in its structural adjustment programmes in 1999.

48. Until the Commission involved all donors in a review of conditionality in the SPA context, donors operated on the assumption that the sectoral and budget reforms required of countries would automatically increase provision of public services. The test carried out in Burkina Faso, in which the Commission coordinated the activities of 12 donors, showed that this was not the case and was followed by proposals for a radical change in methods with a greater emphasis on performance indicators. This complex shift, which the Commission alone has made so far, is beginning to bear fruit. It took two years of discussions in the SPA for this mandate to be conferred on the Commission.

50. The unit responsible for structural adjustment is involved in the sectoral approach both at the level of the SPA (analysis and monitoring of sectoral programmes) and within the Commission, where it jointly chairs a working party producing guidelines in the matter. Implementation has remained in the hands of sectoral units as recommended by the court, with an effort to ensure a coherent approach.

### ***Redirecting the monitoring and control of budget support***

52. The absence of cash-flow problems (the result of countries' efforts and external aid) is the main argument for ending target

ing of budget aid and making funds totally fungible. With or without targeting, the donors must pay more attention to the sound management of public finances.

53. Along with the use of performance indicators, the Commission monitors the application of measures negotiated with governments in the wake of audits. These measures are far more numerous and detailed, including in qualitative terms, than the indicators chosen as conditions for budget aid. The Court of Auditors is undoubtedly aware of the difficulty of finding universally relevant and usable indicators, but the Commission has tried to do so in recent programmes.

Wherever possible — financing proposal following the negotiation of an action plan — account has been taken of this in new aid (Cameroon).

In the case of Senegal, the list of indicators was confirmed in December last year.

54. The new programmes consist of a tranche directly linked to economic performance and another, variable tranche linked to performance indicators. The relative size of these tranches varies according to the countries concerned, their financial situation and the level at which indicators are set. This innovative approach is currently the object of an outside study aimed at optimising the approaches used. It is an established principle that poor performance will lead to reduced disbursements.

55. The Commission shares the view of the Court of Auditors that the targeting of funds should be abandoned in all but exceptional circumstances. This approach has been applied in Commission programmes over the past two years.

The Commission's approach is not confined to checking that an eligible amount of expenditure has been properly executed in priority sectors but also includes an overall examination of the quality of public spending (see below). The proposed approach complements, and is quite consistent with, that advocated by the Court of Auditors.

Box 9

#### **Justifying the eligibility of expenditure**

2. All new financing proposals prepared last year (not just that for Mozambique) provide for the auditing of 'eligible amounts' and wider-ranging checks on the quality of public finances.

56. The Commission advocates a dual approach. Firstly, it wants to make sure that the amount of properly executed spending in priority sectors exceeds the aid provided by the Commission (a requirement applied by other donors). Secondly, it wants to assess, as the Court of Auditors recommends (and where possible with other partners) the overall quality of the management of public finances.

## CONCLUSIONS AND RECOMMENDATIONS

### *General appraisal*

57. The Commission is aware that the situation in the developing countries is difficult and that the situation with regard to governments' management of public finances and the provision of public services is far from ideal. Its approach seeks to be realistic and progressive, aimed at making sure that Community support fosters positive trends, measured according to objective criteria, in these two fundamental areas.

58. All structural adjustment support combines balance-of-payments support with budget support linked to reforms. The Commission has provided support for these programmes while underlining a number of specific concerns. This emphasis has in particular been manifested by the verification of specific conditions not covered by the Court of Auditors's report. The disbursement decisions for these programmes have a political dimension and are taken at Commission level. These decisions sometimes have to tread a fine line between preserving the major financial balances even though some reforms have yet to be carried out and blocking all aid even though progress has been made in some areas. The Commission has for the past two years been applying an innovative approach aimed at providing variable support rather than the 'all or nothing' approach characteristic of earlier programmes.

As for the supervision of counterpart funds, which was examined by the Court of Auditors, it has sought to encourage sound execution of priority budgets (especially in the social sectors). The very principle of targeting is to foster such execution by releasing funds only if budgets are executed. This imposes monitoring of the execution of the targeted budget headings.

Such targeting, associated with conditions, has enabled the Commission to propose and implement a number of key reforms in the interest of the poor: the introduction of essential drugs policies, an increase in budget execution, decentralisation of education budgets to ensure that schools are properly equipped.

59. Supervision by headquarters has normally focused on monitoring the overall programme and compliance with the conditions attached to programmes. Audits carried out by the Commission have gradually made it possible to address the question of public finances in a new way. In particular, they have revealed the limits of the primarily institutional approach previously implemented. It is not enough to improve the rules, the rules have to be enforced. The Commission has therefore paid increasing attention to improvements in the management and control of public finances. It has played an active role in coordinating other donors' activities in these areas (trust fund, SPA).

60. Audits have revealed a number of flaws in the management of national budgets. On the basis of these findings, the Commission is the only donor to have asked for ineligible expenditure to be repaid to the joint-signature (delegation/government) accounts (repayment to the EDF is inconceivable because the irregularities concern counterpart funds belonging to the beneficiary country). It has negotiated action plans aimed at preventing the repeat of errors or abuses observed and has provided institutional support. Lastly, it has in many cases reduced support to countries where major shortcomings have been observed.

61. The Commission, like the Court of Auditors, is aware that improvements in the management of public finances in the developing countries will be gradual and will require time before they are wholly satisfactory. The Commission is therefore using its support to foster improvements in such management. Over the past two years the Commission has gradually introduced into its programmes performance indicators for budget management, chiefly with a view to making sure that budgets actually reach the most decentralised structures and measuring the differences between the prices charged to the public sector and those obtained by the private sector. The Commission has, moreover, proposed the establishment of a trust fund with the World Bank to improve in a coordinated manner the instruments for assessing the quality of public finances and progress made and for identifying reforms to be carried out and institutional support needs. Its current programmes provide for audits and assessments.

### ***Recommendations on the organisation of monitoring***

62. The Commission shares the opinion of the Court of Auditors and has already begun implementing recommendations 1 (a) (b) and (c) aimed at developing a coordinated approach enabling monitoring mechanisms for assessing the quality of budget management to be clearly defined. As for taking account of performance indicators in place of traditional conditions, the Commission has assigned a team to assess the different mechanisms tested in its current programmes.

- (b) As for the yearly nature of audits, the Commission has reservations about the feasibility of carrying out annual financial audits in a context of non-targeted aid and under an approach coordinated with the other donors. It will, however, commit itself to annual checks on budget performance indicators.
- (d) The Lomé Convention does not provide for the EDF to finance technical assistance for the delegations. The distinction between support for the authorising officer (usually the minister of finance) and that for the administration is complex: most technical assistance staff assigned to help the authorising officer in the performance of his duties are also intended to develop his capacities on a wider basis.
- (e) Assessing the quality of the management of public finances calls for an overall approach involving headquarters departments and other donors. It is on this basis that delegations will be able to give an assessment.

63. The Commission undertakes to introduce, as far as possible, provisions on the monitoring and auditing of aid in financing agreements rather than protocols of agreement. As recommended by the Court of Auditors (points 11 and 55), it has for two years been moving in the direction of non-targeted budget aid and will take account of the recommendation (point 5) that the term 'counterpart funds' no longer be used in the context of budget aid.

64. The distinction between the macroeconomic departments and the departments handling the social sectors already applies at the level of programme design (DG DEV) and implementation (AIDCO). The key issue is to ensure overall consistency in the work of units, something the Commission is trying to achieve in relations between units and via the role of delegations and desk officers.

#### ***Recommendations on coordination***

65. Improving the predictability of aid for countries is a matter of constant concern for the Commission and has not always been

easy to implement (interruption of programmes, failure to comply with conditions). The implementation of three-year programmes under the Cotonou Agreement should improve predictability for countries that perform well.

66. The Commission can only endorse the recommendation that coordination of aid under the PRSP be improved. The Commission's key role in supporting this process is acknowledged in the latest World Bank/IMF report.

67. The Commission supports sectoral programmes, which by definition reflect a coordinated approach by donors. It is, after the World Bank, the main donor to such programmes (tracking sector programmes, SPA, December 2000). This approach is aimed at integrating sectoral support into the budget of beneficiary countries. The Cotonou Agreement now authorises the Commission to finance sectoral programmes with budget support where conditions lend themselves to this.

68. The Commission is keen to make sure that the issue of the sound management of public finances and the identification of performance indicators allowing the coordinated measurement of progress in the provision of public services, especially in the social sectors, are dealt with as a matter of priority in the PRSPs. In coordination with other donors, it is developing a coordinate approach to the assessment of public finances (Trust Fund and SPA). This will enable it to pursue the approach initiated in programmes implemented since the end of 1999. Controls now focus on what the Court of Auditors is proposing, namely the assessment of the overall quality of public finances based on audits carried out, wherever possible, with other donors, establishing indicators for measuring progress and developing reform programmes. In response to the recommendations of the Court of Auditors, the Commission also proposes to check that a sum equivalent to its aid has, in priority sectors, enabled fundamental expenditure to be properly financed: in particular, audited arrears, the wages of primary schoolteachers, nurses, doctors and other expenditure vital to reducing poverty.