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INFORMING THE APPROACH OF MULTILATERAL DEVELOPMENT BANKS TO USE OF COUNTRY SYSTEMS

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EXECUTIVE SUMMARY

A greater use of countries' public financial management (PFM) and environmental and social frameworks (ESFs) could offer developing countries a larger stake in their development trajectory. Greater use of country systems (UCS) will also assist developing countries to enhance their capacity (through strengthened legislation, regulations and institutions) to better manage this process. Multilateral development banks (MDBs) have a significant role to play in this process by facilitating infrastructure finance to developing countries using domestic PFM and ESF systems. However, significant political and technical challenges hinder greater uptake of a UCS approach by MDBs. These challenges include increased financial, reputational and development risks; persistently weak country systems; wavering or questionable commitment to the UCS agenda; significant procurement issues in MDB-financed projects; and inadequate capacity of key stakeholders. This briefing (drawing on a more in-depth discussion

POLICY RECOMMENDATIONS

1 MDBs should move away from a 'one-size-fits-all' approach to one that is tailored to a specific country.

2 MDBs should maintain a physical presence in a borrowing country, as an efficient and effective way to promote greater UCS while managing risks better. Country offices should be equipped with appropriate staff and the decision-making power to adequately support this process.

3 Various risk mitigation options (eg, increased use of technology or innovative policy mechanisms, such as the PfR) could be used by MDBs to mitigate bigger risks in their uptake of UCS.

4 Capacity building remains a vital component in UCS. It is important to develop tailored capacity-building plans that take into account differences between countries and strengthen systems as a whole, rather than just individuals.

5 Developing countries should signal their clear commitment to a greater UCS agenda by investing in strengthening their domestic PFM and ESF systems.

paper) highlights these challenges and offers recommendations on how MDBs and borrowing- and non-borrowing countries can contribute to greater UCS.

INTRODUCTION

Most countries consider infrastructure development as a key enabler of development, by spurring job creation, trade and investment. For many developing countries, which face growing infrastructure financing deficits, MDBs remain important in addressing these deficits. MDBs offer countries attractive interest rates, long repayment and grace periods on loans, and decades' worth of technical experience on development projects. In facilitating loans to countries, MDBs have historically dictated the terms of finance by prescribing rules on financial management and environmental and social safeguards. Such terms are enforced alongside and despite the presence of similar systems in the relevant countries. Increasingly, however, both MDBs and their borrowers are seeking to eliminate these extra requirements in favour of the full utilisation of countries' own domestic systems and processes, broadly referred to as UCS.

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The defining benefit of greater UCS by MDBs is that it respects the sovereignty of countries by not imposing external conditionalities. UCS also promotes national ownership of development projects by encouraging the involvement of domestic actors, institutions and processes, and hence increasing their sustainability.[2] At the same time, UCS can strengthen domestic systems through greater utilisation, thereby exposing deficiencies that can be corrected[3] and eliminating the duplication of costs and efforts. Ultimately, UCS gives developing countries a greater stake in their own development trajectory, as well as the tools to manage the process better.

While MDBs have made some progress in increasing UCS through the above-mentioned initiatives, scaling up utilisation of domestic systems has been challenging for both MDBs and borrowers

Most development partners and countries have made commitments towards greater UCS. The first firm commitment in this regard was undertaken in the Paris Declaration on Aid Effectiveness (PDAE) in 2005, and was confirmed in subsequent policy processes such as the Accra Agenda for Action (2008), the Busan Global Partnership Agreement (2011), the Addis Ababa Action Agenda (2015) and the Nairobi Outcome Document of the Global Partnership for Effective Development Co-operation (2016). MDBs have also committed to this agenda by partaking in these processes and, through the introduction of UCS pilot programmes, developing new operational policies (such as procurement or ESF) that place UCS at their centre.

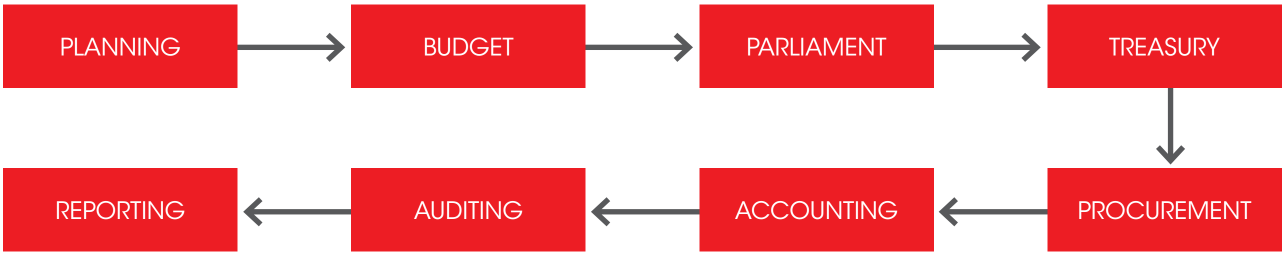
While MDBs have made some progress in increasing UCS through the above-mentioned initiatives, scaling up utilisation of domestic systems has been challenging for both MDBs and borrowers. Yet this does not negate the pressing need to address and promote further cooperation. This policy briefing is based on a discussion paper from the Global Economic Governance Africa programme, drawing on the UCS experiences of Kenya, South Africa and Morocco in MDB-financed projects.[4] The recommendations aim to assist MDBs in refining their approach to UCS.

USE OF COUNTRY PFM AND ESF SYSTEMS

UCS in the context of MDB loans relies on two overarching domestic systems: PFM processes and ESFs.

PFM involves a number of core functions undertaken by governments to manage public finances, illustrated sequentially in Figure 1.[5]

FIGURE 1: KEY FUNCTIONS OF PFM



Source: CABRI (Collaborative Africa Budget Reform Initiative), *Towards a Greater Use of Country Systems in Africa: Recent Trends and Approaches*, August 2014, http://www.cabri-sbo.org/en/publications/towards-a-greater-use-of-country-systems-in-africa-recent-trends-and-approaches-synthesis-report, accessed 15 August 2017

In the case of infrastructure, for example, project development implies that a particular infrastructure project can be tracked from the planning through to the public reporting phase. Within the context of PFM and UCS, procurement is the most contested and controversial aspect.

ESF refers to the collective legislation comprising environmental and social safeguards, as well as the subsequent implementation and enforcement of these safeguards. Various pieces of legislation typically set out the measures that must be assessed ahead of the implementation of infrastructure development projects, including a range of environmental and social impact assessments. No country has a uniform set of laws, and each project will trigger a different combination of laws given the differing environmental and social impacts.

The difficulty in formulating an approach to UCS lies in the complexity of these systems: PFM and ESF are not singular and succinct processes, but are made up of a number of smaller, inter-related processes, which in turn comprise various actors, institutions and legal frameworks. These differ across countries, levels of government and sectors, and tend to be dynamic. While MDBs in the past applied largely singular systems across all countries, greater UCS requires a move away from such a 'one-size-fits-all' approach towards an approach tailored to each specific country. This is an uncomfortable truth for most MDBs, as this stands to greatly increase their costs and arguably decrease their competitive advantage by making their loans more expensive. However, this shift does not absolve borrowing countries from contributing towards greater UCS. Borrowing countries need to signal clear intent towards the UCS agenda through, for example, addressing deficiencies in their country systems.

Challenges to greater UCS

Despite the significant benefits and potential that UCS holds, there are a number of key obstacles facing current UCS approaches that limit greater uptake and development impact.

Risk mitigation. By using country systems, MDBs face increased financial and reputational risks, with a greater possibility of inadvertently causing adverse development impacts.By abandoning MDB safeguards aimed at preventing financial mismanagement or abuse, country systems, which might be more susceptible to such abuses, stand to disadvantage both MDBs and countries financially. In a similar manner, the safeguards insisted on by MDBs endeavour to limit reputational damage to institutions and ensure the best development outcomes. MDBs have in the past experienced significant reputational damage from gross environmental or social violations in their projects, with the attendant negative development impacts.[6] Given these core risks to MDBs and countries, it is therefore understandable that MDBs would wish to impose additional safeguards beyond what country systems offer. While these safeguards have been useful to countries as a minimum baseline for PFM and ESF standards, over time many of these policies have accumulated and become (arguably) excessively stringent, to the extent of adding unnecessarily to the costs, time and bureaucracy of infrastructure projects.

> The additional safeguards imposed by MDBs are often inflexible and incompatible with domestic systems, and exemplify the 'one-size-fits-all approach'

Compounding this problem is the view that the additional safeguards imposed by MDBs are often inflexible and incompatible with domestic systems, and exemplify the 'one-size-fits-all approach'. Innovative mechanisms, such as the World Bank's Programme for Results (PfR), which links disbursements of funds to measurable development outcomes, with less focus on processes, have been favourably received by many countries. Having country offices that are staffed with local experts who understand the domestic environment and systems can also help mitigate risks by their managing day-to-day activities and working closely with project partners.

Strengthened country systems. Additional safeguards are often instituted by MDBs because all country systems are not equal in mitigating risks. Since the PDAE's call to move away from such safeguards, however, mixed results have been seen in terms of strengthened country systems. The Organisation for Economic Co-operation and Development and the World Bank's indices[7] measuring PFM systems in developing countries have indicated signs of both improvement and regression. While certain countries have made sincere efforts to improve their governance processes, others have failed to do so. In other cases, while legislation around governance processes has been strong, the implementation, monitoring and enforcement of these systems have been insufficient. Borrowing countries need to demonstrate the will to address such shortcomings if they want to increase usage of their systems in MDB-financed projects. This also requires a greater prioritisation of domestic financial resources to, for example, bolster capacity-building efforts around PFM and ESF functions.

Commitment to UCS. In addition to the more technical challenges facing UCS, as highlighted above, the political commitment of both MDBs and countries to the UCS agenda is vital if uptake is to be increased. Here, MDBs' institutional dynamics can hinder progress. For example, there are often conflicting perspectives between MDB headquarters and country offices regarding UCS. While headquarters prefer parallel systems that provide adequate safeguards, country and regional offices are more familiar with domestic environments, are often residents of the target country, and have personal relationships with key in-country stakeholders, strengthening their trust in domestic systems and advocacy of greater UCS. However, borrowing countries may also favour UCS for the wrong reasons (eg, because incentives, such as rents, are institutionalised within domestic systems). In other cases, governments may prefer to use MDB systems as they provide political cover by externalising unfavourable decisions.[8]

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Procurement. Procurement remains contentious in the relationship between MDBs and borrowers.[9] Since procurement poses significant financial, reputational and development risks for development projects, MDBs typically prescribe procurement guidelines. This is especially so for larger procurement projects, where international competitive bidding procedures are dictated. While this does increase competition (making procurement more efficient), it has also been done to ensure that companies from non-borrowing member countries benefit from procurement contracts. Non-borrowing member countries, often developed countries, typically hold a large share of voting power in MDBs and can shape policies to benefit their national interests. Such processes tend to exclude domestic companies due to limited capacity, the absence of global supply chain linkages, or inability to meet the standards of the bids.

In addition, procurement rules dictated by MDBs regularly conflict with the development policies of borrowing governments. Many governments use public procurement as a developmental tool to promote industrialisation or address inequality by giving preference to marginalised groups such as women or small and medium-sized enterprises. However,

> Procurement rules dictated by MDBs regularly conflict with the development policies of borrowing governments

the World Bank's procurement rules, for example, specifically prohibit offering 'preference to domestic bidders' or 'splitting of contracts into small lots for purposes of promotion of the participation of small enterprises'.[10] The governments of developing countries argue that giving them greater control over procurement will create more spill-over benefits from infrastructure projects, such as job creation and capacitation of locally owned companies.

Capacity building. Capacity and capacity building have significant implications for facilitating greater UCS. One needs to consider the capacity of both MDBs and borrowers to employ UCS. Do MDBs have the human and technical staff capacity to support such processes? Such requirements can often be extensive, based on the country's level of PFM/ESF development and the technical and capacity-building support required. Similar questions need to be raised regarding the capacity of governments and subsidiary institutions to manage activities associated with increased UCS, such as the technical, accounting, procurement and legal aspects of loans, or highly specialised environmental and social impact assessment and management. The capacity of civil society should also not be neglected. Civil society plays an important role in keeping government accountable to domestic PFM and ESF processes. This is vital where MDBs relinquish more control to governments through UCS. It is important to note that where capacity building is undertaken, a holistic approach should be taken that strengthens country systems as a whole, rather than just capacitating individuals who could be easily removed from a system.

Thus, while some of the challenges and contentions around UCS are overstated, misplaced or perceived, there are often also legitimate concerns. There is a need for MDBs and their borrowing and non-borrowing shareholders to isolate the political and technical underpinnings of challenges to UCS, and address them accordingly.

RECOMMENDATIONS

Historically, MDBs have adopted an 'MDB-light, country-heavy' approach where the burden of engagement and compliance was shifted onto borrowing countries. However, this approach requires revisiting, as there are benefits for both MDBs and borrowers in a more equitable relationship. This means that MDBs should move away from a 'one-size-fits-all' approach to one that is tailored to a specific country.

Risk management

It is clear that greater UCS could signal more risks for both parties, and that adequate risk mitigation measures need to be adopted that do not hinder greater uptake of UCS. While MDB safeguards have historically proved to be a useful baseline for infrastructure projects, they are often also excessive. Rather than dictating this baseline, MDBs, in developing their own guidelines, could be guided by international agreements that are widely subscribed to. Examples include the Convention on International Trade in Endangered Species, which 182 countries have signed, or the policies of their member states (both borrowing and non-borrowing members). MDBs could also leverage technology to improve governance and mitigate risks. For example, the introduction of e-services in procurement, with a strong focus on public disclosure, will achieve efficiency gains and enhance transparency. Innovative disbursement mechanisms such as the World Bank's PfR, which predicates the release of funding on positive development outcomes and in turn allows countries more flexibility in using their own systems, can also be leveraged. MDBs should more frequently adopt a simple yes/no approach to financing.[11] This would allow countries to submit projects for financing based on their domestic systems – if projects are deemed fundamentally flawed, MDBs simply choose to not finance them. On the other hand, if minor adjustments could be made that would allow projects to pass MDB safeguard thresholds and countries are willing to act accordingly, MDBs could consider financing them.

Capacity building

Borrower capacity is a vital component of UCS. A clear capacity-building strategy, developed by each country in conjunction with MDBs, would be useful. When developing such strategies, it is important to remember that it is not enough to have project-specific capacity-building components, but that a more comprehensive approach should rather be followed that allows for the strengthening of a system as a whole. Capacity-building strategies should also not neglect civil society. Various sectors of society, including the media, academia, non-governmental organisations and those vulnerable to the negative effects of infrastructure development, are important actors in PFM and ESF processes and should have adequate knowledge, capacity and avenues to engage on such matters. The proposed capacity-building strategy should also consider financing capacity-building activities. MDBs could consider levying a special fee on loans to raise revenue that is ring-fenced for capacity building. The prospect of making loans more expensive might be discouraging, but considering how vital capacity building is, this should at least theoretically receive support from MDBs and borrowers.

MDB and country buy-in

MDBs and borrowers' commitment to UCS is a critical success factor for greater UCS. The level of support for UCS differs from country to country. In our broader study three different attitudes towards UCS were identified: South Africa views UCS as non-negotiable; Morocco takes a more pragmatic view by identifying weaknesses in its own systems and displaying a willingness to compromise on these shortcomings by using MDB systems for select functions; and Kenya recognises that its domestic processes often fall short of international best practices and is happy to work with a 'hybrid' country–MDB system.[12] Assessing the intent of countries at an individual level, rather than taking a blanket approach, would be useful in this regard. Even within countries, certain sectors or institutions might indicate a greater intent on UCS, which can be used as an entry point for MDBs in using country systems. This could form part of a phase-in approach.

Country offices

The physical proximity of MDBs to their clients is important. Having a physical presence in a country, with offices staffed by locals who understand the business culture and operating environment well, and where close networks with key stakeholders can be built, is vital for greater UCS. Not only do locals assist in mitigating risks for MDBs but their familiarity with domestic systems has also often made them key proponents of greater UCS. It is vital that such offices are adequately equipped – in terms of both staff capacity and decision-making power – to carry out the UCS mandate.

Conclusion

Greater UCS holds significant potential for both MDBs and borrowing countries. However, UCS calls for a more equitable share and responsibility in development efforts from both MDBs and borrowers: MDBs should look to overcome technical challenges to surrender more functions to borrowers, and borrowers should improve their country systems in order to allow greater usage by MDBs. Equally, the role of non-borrowing members should not be discounted: by often holding the greatest share of votes in MDBs, and therefore directly influencing the policies of these institutions, this would require sacrifices on their part too.

Endnotes

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