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The Consequences of **Donor-Induced Fragmentation**

Donor-induced fragmentation of public financial management systems reduces reputation risk, but it unambiguously increases development risk – the longer-term risk of not achieving development objectives. Three levels of donor-induced fragmentation are identified in this paper: i) fragmentation of budgets and resource allocation systems; ii) fragmentation in accounting and classification systems; and iii) fragmentation in systems for scrutiny. These three levels of fragmentation results in fragmented accountability, which ultimately increases fiduciary risks.

Fragmentation can occur as a result of donors preferring to bypass government systems for fiduciary and reputation-risk reasons. But this can cause serious problems, including loss of accountability, poor consolidated reporting, and inefficient allocation of resources. Bypassing systems is unlikely to significantly reduce exposure to fiduciary risk – the shorter-term risk of misuse of funds. The practice can actually increase fiduciary and corruption risks under certain circumstances, when fragmentation creates more holes in systems that can be exploited.

Aid dependency magnifies the problems of donor-induced fragmentation contributing to aid-induced "resource curse" problems[1] and an aid dependency trap. Fragmentation in these circumstances constrains systems from being able to become strong enough to deliver efficient and effective government. For example, consolidated, comprehensive, and policy-based budgeting built on a system of rolling forward estimates of the costs of existing policy, fiscal space parameters, and policy change becomes very difficult – if not impossible - in fragmented and aid dependent systems. Non-aid dependent countries are in much a stronger position to protect the integrity of the budget cycle, which is effectively a government's continuous improvement cycle that helps a government become more efficient and effective over time.

BUDGET FRAGMENTATION

Budget fragmentation can take many forms. The most common form is the separation of operating and development budgets. The major cause of fragmentation problems from development budgets is the lack of budgeting in accordance with chart of accounts used for the operating budget, thereby

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making it impossible to consolidate budgets in a high quality budget finance statement. The problems of the separation are magnified when there is institutional fragmentation for the operating and development budgets, which is often the case in aid-dependent countries. In many developing countries, the ministry of finance is responsible for the operating budget and a ministry of planning is responsible for the development budget.

Projects and multi-donor trust funds that are off-budget are, by definition, fragmentised systems. Projects and multi-donor trust funds that are reported in annual budget papers, but are outside the standard budget preparation cycle of government, still constitutes fragmented budgeting. Another form is when the development budget is in a different currency to the operating budget.

Fragmentation in budgets and resource allocation means that all resources are not being allocated at the same time. Allocative efficiency – allocating resources to the highest priority areas or areas that have the greatest social and economic impact – is best supported through a consolidated and comprehensive approach to budgeting. Fragmented resource allocation breaches this core public finance principle for good budgeting, which ensures that:

- only the fiscal policies with biggest impact or the most important get approved; and
- fiscal balance targets – and therefore fiscal sustainabilities – are properly protected.

Bypassing a single budget process allows incremental financing decisions – permitting low impact spending proposals through and enabling ad-hoc lobbying by vested and single-issue interests. Moreover, weak project budgeting financed through multi-year grants obscures fiscal sustainability issues and establishes perverse incentives for unrealistic annual budgeting. This further compromises the integrity of the budget. Weak oversight of annual project budgets linked to multi-year grant agreements results in consistently poor reportable budget execution performance. Indicators of weak oversight in this area are the extent of no-cost grant extensions and high-required disbursement rate multiples to close a multi-year grant on time with zero balance.

ACCOUNTING FRAGMENTATION

Fragmentation in accounting means different classifications are used making it difficult to consolidate budgets and accounts. An example of the problems this causes is when projects provide consultants that are filling line positions and providing top-up salaries to governments. When this happens, it is impossible to know from reviewing the budget statements the cost of compensating employees. Another example is when a project classifies spending in accordance with thematic or activity description (e.g. capacity building) as opposed to the classic input (object or economic) classification system (e.g. salaries, goods, capital) used almost universally around the world, making classification mapping very difficult or impossible.

Fragmentation in accounting also means that accounting rules followed by projects may be different. For example, if a project uses accrual accounting and the government systems uses cash accounting, it becomes difficult to produce consolidated financial statements. Another example is when the government uses commitment controls and tracks age of expenditure arrears, and project accounting systems does not. This form of fragmentation unambiguously increases exposure to fiduciary risk, since the government system is easily able to detect facilitation payment potential, while the project system cannot without special investigations. Another example where fragmented accounting unambiguously increases fiduciary risk is when the government uses a high quality financial management information system that has audit trails of every transaction, while the project or multi-donor trust fund uses a spreadsheet as their general ledger. An inability to check who made changes to a general ledger makes it more difficult to detect and prosecute malfeasance.

The consequences of fragmentation in accounting include the inability of a government cabinet to make informed resource allocation decisions, and the constraining of scrutiny by parliament. For example, an obscured picture of the cost of employees may lead to a blow out of a wage bill or uncontrolled expansion of the public service. Another consequence is that the lack of a consolidated financial statement means that external auditing of that statement cannot occur.

FRAGMENTATION IN SCRUTINY

Fragmentation in reporting and scrutiny means audits do not comply with the single audit principle. The single audit principle is based on the idea that each level of control builds on the preceding one. The aim of single audit is to prevent duplication of control work, reduce the overall cost and audit activities, and decrease administrative burden. Separate audits of separate accounts make it difficult to detect certain types of fraud and mismanagement, such as booking the same expenditure twice in different accounts. Donor financed projects or audits linked to multi-donor trust funds can often mix up internal audit and external audit functions. Whereas an internal audit primarily serves as an internal early warning function, an external audit on reliability of financial statements provides an independent verification function. External and internal audit planning can be compromised when the single audit principle is not followed.

Accounting standards have been set to help deal with donor-induced fragmented systems. These are associated with non-mandatory standards for 3rd party payments and (draft) disclosure requirements for recipients of external assistance. Such standards are often not followed, partly due the complexity of problems caused by the fragmentation.

Detecting fraud can be more difficult in fragmented budgets systems. Having fragmented budgeting and accounting systems, means that it is very easy to report the same expenditure twice – once in the operating budget accounts and again in a different set of accounts such as a project, multi-donor trust fund, or a development budget. Detecting this form of fraud becomes even more difficult when there are different auditing systems being used. A project audit, will never be able to reliably detect double dipping expenditure.

WHAT CAN BE DONE?

Dealing with donor-induced fragmentation is difficult. Donors and recipients have been dealing with the problem for decades. Attempts include efforts to use country systems more and innovative forms of budget support and performance-linked aid.

A four-part solution is proposed:

1. **Focus more on development risk,** not just fiduciary risk as a core issue – enabling donor-induced fragmentation to be treated as a problem to be solved;
2. **Target defragmentation** in fiscal performance improvement plans;
3. **Use team-based performance management** as the implementation mechanism that holds teams responsible for delivering fiscal performance improvement – enabling higher levels of accountability; and
4. **Create a new accountability deal with donors** to provide flexible resourcing enabling defragmentation in return for more accountability around performance.

Note:

1. The resource curse refers to the general observation that, since the 1970s, certain countries rich in natural resources have achieved a slower rate of economic growth than resource-poor countries. There are four main theories: i) Dutch disease; i) rent seeking and governance; ii) volatility; and iii) non-tradable specialization and financial market imperfections. These theories have been applied to aid flows to developing county economies. The Dutch disease explanation focuses on macroeconomic factors, while the other theories are more microeconomic or institutional in nature. Dutch disease theory says that significant increases in revenues from resources shift the domestic production to non-tradable (e.g. construction and domestic services). This shift happens because the increase in income leads to an increase in demand for goods and services overall, but since non-tradable have to be produced locally, the economy becomes more focused on the production of non-tradable. But this only implies that resource or revenue booms cause a contraction in manufacturing (tradable). The next step is crucial to the Dutch disease explanation. It is founded on the notion that the tradable goods sector is better for growth than the non-tradable sector. It follows that any shift from the former to the latter results in less economic growth than would otherwise be the case. An important issue to note is that the Dutch Disease explanation still recognizes that high growth driven from massive revenue windfalls still occurs in the short-run. In the medium term after the domestic economy has adjusted to the new structure, growth will be slower than if the domestic economy did not adjust. That is, slower economic growth at a higher-level national income. (See Davis, Ossowski, Fedelino, 2003, “Fiscal Policy Formulation and Implementation in Oil-Producing Countries”, IMF). Aid-induced Dutch disease arises for exactly the same reasons as that due to increased revenues from resources. That is, it arises if aid causes a shift away from the tradable to non-tradable goods sectors, which is bad for growth on the grounds stated above. The rent seeking theory for the resource curse is founded on the notion of the common pool problem - where costs are borne by many but the benefits are enjoyed by a few. When there is large common pool of funds, such as in an aid dependent country, incentives to work harder at seeking rents from that pool become stronger.