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Promoting the Use of Country Systems in ADB's Operations

A Systematic Approach

ABBREVIATIONS

ADB	–	Asian Development Bank
PRC	–	People’s Republic of China
CPAR	–	country procurement assessment report
CPS	–	country partnership strategy
DMC	–	developing member country
GACAP II	–	Second Governance and Anticorruption Action Plan
IADB	–	Inter-American Development Bank
ICB	–	international competitive bidding
IPSAS	–	International Public Sector Accounting Standards
LIC	–	low-income country
LMIC	–	lower middle-income country
MAPS	–	Methodology for Assessing Procurement Systems
MDB	–	multilateral development bank
NCB	–	national competitive bidding
OECD-DAC	–	Development Assistance Committee of the Organisation for Economic Co-operation and Development
PEFA	–	Public Expenditure and Financial Accountability
PFM	–	public financial management
RAMP	–	risk assessment and risk management plan
RBL	–	results-based lending
SPS	–	Safeguard Policy Statement
UMIC	–	upper middle-income country

NOTE

In this report, “\$” refers to US dollars.

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EXECUTIVE SUMMARY

The Asian Development Bank (ADB) is committed to promoting the use of country systems in its operations. The use of country systems is expected to reduce delays in project implementation, rationalize transaction costs, improve country ownership, and strengthen the institutions and systems of ADB's developing member countries (DMCs) to improve service delivery and achieve sustainable development. ADB will consider three areas of country systems that are central to achieving sustainable development impact: procurement, public financial management (PFM), and environmental and social safeguards.

For considering a systematic start to the use of country systems, this paper began with a quest to arrive at an exclusive approach to the use of country systems in ADB's upper middle-income countries (UMICs), based on the expectation that UMICs generally have higher institutional capacities and well-functioning country systems, and are hence expected to be associated with lower fiduciary and safeguards risks for ADB. Use of country systems by ADB, and improving the quality of its assistance for its UMICs, is an integral part of the proposed broader UMIC approach developed under the Strategy 2020 Midterm Review action plan.

However, preliminary analyses on the strength of country systems of selected UMICs show that no UMIC currently qualifies for full and unreserved use of country systems in ADB projects because of their lack of equivalence on one or more dimensions of country systems with ADB's policy and procedural standards and requirements. At the same time, the strength of country systems of individual DMCs varies significantly. A uniform approach in promoting the use of country systems in ADB UMICs as a group is, therefore, not feasible. ADB requires a context-specific approach for each DMC consistent with the strength of its systems, capacities, and its demand for the use of its systems in ADB operations.

To enable learning by doing, ADB will take a phased approach to the use of country systems. Under the Phase 1 (2015–2017), ADB will systematically explore the use of country systems in six selected DMCs, including UMICs, which are considered to have well-functioning internal systems, and are hence expected to be associated with lower fiduciary and/or safeguard risks for ADB. These six DMCs are: the People's Republic of China, Fiji, India, Indonesia, Kazakhstan, and Sri Lanka. The actual use of country systems, however, will continue to depend on a DMC's preferences for using ADB's or its own systems, and its institutional capacities at the central and local government levels.

Procurement and public financial management systems. Under its results-based lending and policy-based lending modalities of support to DMCs, ADB already accepts the use of country systems. For its investment lending operations, ADB has made important changes in its approach to assessing country procurement systems, and has introduced a risk-based approach to procurement under a 10-point procurement reform action plan adopted in August 2014—this will potentially allow greater use of country procurement systems in ADB operations.

ADB will implement the following framework in systematically assessing the feasibility and promoting the use of country systems, in Phase 1. Comprehensive governance risk assessments and management plans will be ADB's primary instruments for assessing the risks and feasibility of using country procurement and PFM systems. Staff guidelines for the implementation of ADB's Second Governance and Anticorruption Action Plan (GACAP II) were revised in December 2014 to reflect this focus.

- (i) **Undertaking robust governance risk assessments and analyses (2015).**
ADB will fast-track robust governance risk assessments and analyses in the six

DMCs (based on the new GACAP II guidelines), and prepare a country systems profile on each DMC, with staff's professional judgment on the procurement and PFM systems that ADB can rely on for use in its operations, and those where gap-filling measures will be required, if country systems are to be used.

- (ii) **Preparing road maps for the use of country systems (2015–2016).** ADB will initiate strategic dialogues in selected DMCs, based on the results of the country systems profiles. Country teams, in consultation with the DMCs, will identify at least one sector and/or agency where the use of country systems could be pilot tested, and prepare a road map with time frames and capacity strengthening requirements.
- (iii) **Implementing road maps and supporting institutional development (2017).** Project teams will implement these road maps and pilot test the use of country systems in dimensions of procurement and PFM systems that can be used by ADB.

Safeguard systems. ADB's Safeguard Policy Statement (2009) commits the institution to strengthen the country safeguard systems of DMCs in the three areas of environmental assessment, involuntary resettlement, and indigenous people. The policy allows for the use of country safeguard systems, subject to equivalence and capacity assessments. Initial equivalence assessments of UMICs show that no UMIC qualifies for full use of any of the three dimensions of country safeguards systems in ADB projects. Still, recognizing the progress made by DMCs on strengthening environmental policies and legal frameworks, ADB will initiate strategic dialogues in selected DMCs, prepare country environmental systems profiles and road maps for the use of country environmental systems in ADB's operations.

ADB will also take the following actions to implement the use of the country systems approach systematically and to promote the use of these systems in ADB operations:

- (i) **Remove procurement policy impediment.** ADB will review its procurement policy in 2015, and consider amendments to allow the use of country systems in its operations, including in its investment lending operations.
- (ii) **Implement Second Governance and Anticorruption Action Plan new guidelines rigorously.** ADB will ensure rigorous implementation of the staff guidelines to undertake robust governance risk assessments and risk management plans. Ultimately, the implementation of these guidelines, and resulting assessments of DMCs, will determine the feasibility of the use of country systems, consistent with the capacities and strengths of procurement and PFM systems in individual countries.
- (iii) **Revise country partnership strategy guidelines.** Country partnership strategies should reflect the results of governance risks and environmental systems assessments and analyses, and present progress made on strengthening and the use of these country systems. Such assessments, which can be prepared independently of the country partnership strategy process, will inform strategic consultations on the use of country systems at the country, sector and/or project level. Country partnership strategy guidelines will be revised accordingly.

Under the Phase 2, ADB will refine its approach to the use of country systems from the point of view of ultimately mainstreaming this approach in eligible DMCs, based on lessons from the Phase 1, and in light of the evolving changes in policies and approaches of other multilateral development banks toward the use of country systems.

I. INTRODUCTION

1. The Asian Development Bank (ADB) is committed to strengthening and promoting the use of country systems in its operations.¹ ADB has endorsed the global declarations on aid effectiveness, which make a strong case for the use of country systems by the providers of development assistance to improve the development impact of their operations. The use of country systems is expected to reduce delays in project implementation, rationalize transaction costs, improve country ownership, and strengthen the institutions and systems of ADB's developing member countries (DMCs) to improve service delivery and achieve sustainable development.

2. ADB has supplemented its DMCs' efforts to strengthen country systems and build local capacities through its operations, and has introduced modalities and measures that will potentially improve the use of country systems in its operations. However, ADB has not taken a systematic approach to the use of these systems in its investment lending operations. Three areas of country systems that are considered central to achieving sustainable development impact are procurement, public financial management (PFM), and environmental and social (involuntary resettlement and indigenous peoples) safeguards.

3. This paper began with a quest to arrive at a common approach to the use of country systems in ADB's upper middle-income countries (UMICs). This is based on the expectation that UMICs generally have higher institutional capacities and well-functioning country systems, and are hence expected to be associated with lower fiduciary and safeguards risks for ADB. The use of country systems by ADB is a fundamental part of its efforts to improve the quality of its assistance and relevance for its UMICs, as highlighted in the proposed broader UMIC approach developed under the Strategy 2020 Midterm Review action plan.² Improving the quality of its assistance, and the development impact of its support to middle-income countries, is one of ADB's strategic priorities under its Midterm Review of Strategy 2020.³

4. In keeping with the scope of the proposed UMICs approach (footnote 2), this paper analyzes the strength of country systems in six of ADB's 14 UMICs.⁴ These six DMCs are Azerbaijan, the People's Republic of China (PRC), Kazakhstan, Malaysia, Thailand, and Turkmenistan. Initial analyses based on available assessments (presented in this paper) conclude that no UMIC currently qualifies for full and unreserved use of country systems in ADB projects because of their lack of equivalence on one or more dimensions of country systems with ADB's policy and procedural standards and requirements. At the same time, these six UMICs vary significantly with respect to the strength of their country systems. Therefore a uniform approach to the use of country systems in the UMICs as a group is not feasible.

¹ Country systems typically include national arrangements and procedures for public financial management (PFM), procurement, results, monitoring and evaluation, and social and environmental procedures. Use of country systems refers to the use of a country's national, subnational, or sectoral implementing institutions and applicable laws, regulations, rules, and procedures for the activity or operations being supported by ADB.

² ADB. 2015. *Clients–Contributors–Collaborators: A New Partnership with Upper Middle-Income Countries*. Manila.

³ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

⁴ ADB's 14 UMICs (based on the World Bank definition of per-capita gross national incomes of \$4,126–\$12,745) include three DMCs from East and Southeast Asia: the People's Republic of China (PRC), Malaysia, and Thailand; three in Central Asia: Azerbaijan, Kazakhstan, and Turkmenistan; seven island states in the Pacific: the Cook Islands, Fiji, the Marshall Islands, Nauru, Palau, Tonga, and Tuvalu; and the Maldives, another island state in South Asia. The UMICs paper excludes small island economies from its scope since they face unique development challenges where more specific development interventions are required. ADB's approach to fragile and conflict-affected situations is summarized in ADB. 2013. *Operational Plan for Enhancing ADB's Effectiveness in Fragile and Conflict-Affected Situations*. Manila.

Instead, a context-specific approach to the use of country systems is required, based on the strength of these systems, capacities, and demand by individual DMCs for the use of their systems. Preliminary analyses on safeguards also suggest that it is too early to consider the use of country systems on involuntary resettlement and indigenous peoples in the short term, since significant gaps exist in the six UMICs' national laws and the respective principles under ADB's Safeguard Policy Statement (2009).

5. This paper provides a common framework for ADB's systematic approach to the use of country systems in its sovereign investment lending operations. ADB will consider the use of country systems in three areas: procurement, PFM, and environmental safeguards.⁵ To enable learning by doing, the proposed framework will be implemented in Phase 1 over a 3-year period (2015–2017) in six selected DMCs that have well-functioning internal systems. In 2018, in its Phase 2, ADB will review and refine its country systems approach based on its Phase 1 experience and in light of other development partners policies and approaches.

6. Section II summarizes the rationale for using country systems. Section III presents analysis on the strength and suitability for use of the country procurement and PFM systems of the six UMICs in ADB's operations; and Section IV presents similar analysis with respect to the country safeguard systems. These sections also review the adequacy of ADB's policy provisions and business processes and tools, to assess and operationalize the use of country systems in ADB operations. Section V presents a common framework for assessing the feasibility and promoting the use of country systems in ADB, which will be implemented in selected DMCs during Phase 1.⁶ The paper also identifies policy impediments and other issues that ADB should address to facilitate a systematic move toward the use of country systems in its investment lending operations.

II. WHY USE COUNTRY SYSTEMS?

7. Global declarations on aid effectiveness (Paris, Accra, Busan, and Mexico) and other development effectiveness literature make a strong case for the use of country systems by providers of development finance.⁷ ADB has endorsed these international declarations and is committed to this agenda. The main argument for using country systems is to shift the focus both of ADB (and other providers) and DMC governments toward strengthening countries' own systems and institutional capacity (as opposed to using parallel systems), and thus improve the development impact and sustainability of development initiatives. Development literature provides a number of examples where the use of country systems has contributed to establishing widely accepted practices and enhancing domestic accountability processes.⁸ The

⁵ The use of country systems on the other two safeguard issues (involuntary resettlement and indigenous peoples) is not being considered in Phase 1.

⁶ In the rest of the document, reference to investment lending operations should be read as sovereign investment lending operations, since the proposed framework will be implemented only with respect to sovereign operations in Phase 1.

⁷ *Paris Declaration on Aid Effectiveness 2005; Accra Agenda for Action 2008; Global Partnership for Effective Development Cooperation 2011; Mexico High Level Meeting Communique 2014; Cusco Declaration on Procurement and Manila Consensus on PFM 2011*; and other aid effectiveness documents. Organisation for Economic Co-operation and Development (OECD). Development Co-operation Directorate. Aid Effectiveness. www.oecd.org/dac/effectiveness.

⁸ T. Williamson et al. 2008. Building Blocks or Stumbling Blocks? The Effectiveness of New Approaches to Aid Delivery at the Sector Level. *Good Governance, Aid Modalities and Poverty Reduction Working Paper Series*. No. 6. London: Overseas Development Institute; Mokoro and Overseas Development Institute. 2009. Sector Budget Support in Practice: Case Study – Education Sector in Rwanda.

use of country systems is also expected to reduce the transaction costs associated with managing development assistance for ADB and its DMCs in the long term.

8. State institutions can only be efficient and ensure effective service delivery for their citizens when such institutions are underpinned by robust PFM and procurement systems that are transparent and accountable. Similarly, socially inclusive and environmentally sustainable growth requires well-performing systems and capable institutions, which can avoid, minimize, and mitigate adverse environmental and social impacts of development initiatives.

9. The use of country systems is expected to improve country ownership, and to build capable institutions and effective systems necessary for better service delivery and for achieving sustainable development. Behind the attempts to focus on the use of country systems is an effort by the international community to highlight the importance of establishing widely accepted good practices and processes in all aspects of country systems, and to provide assurance that development assistance will be used for its intended purposes. ADB needs to start a systematic dialogue on strengthening the country systems and their use in its investment lending operations, and to achieve a balance between a transaction control culture that primarily aims to meet project level fiduciary requirements, with that of building local institutional capacities systematically.

III. USE OF COUNTRY PUBLIC FINANCIAL MANAGEMENT AND PROCUREMENT SYSTEMS IN UPPER MIDDLE-INCOME COUNTRIES

A. Strength of Public Financial Management and Procurement Systems of Upper Middle-Income Countries

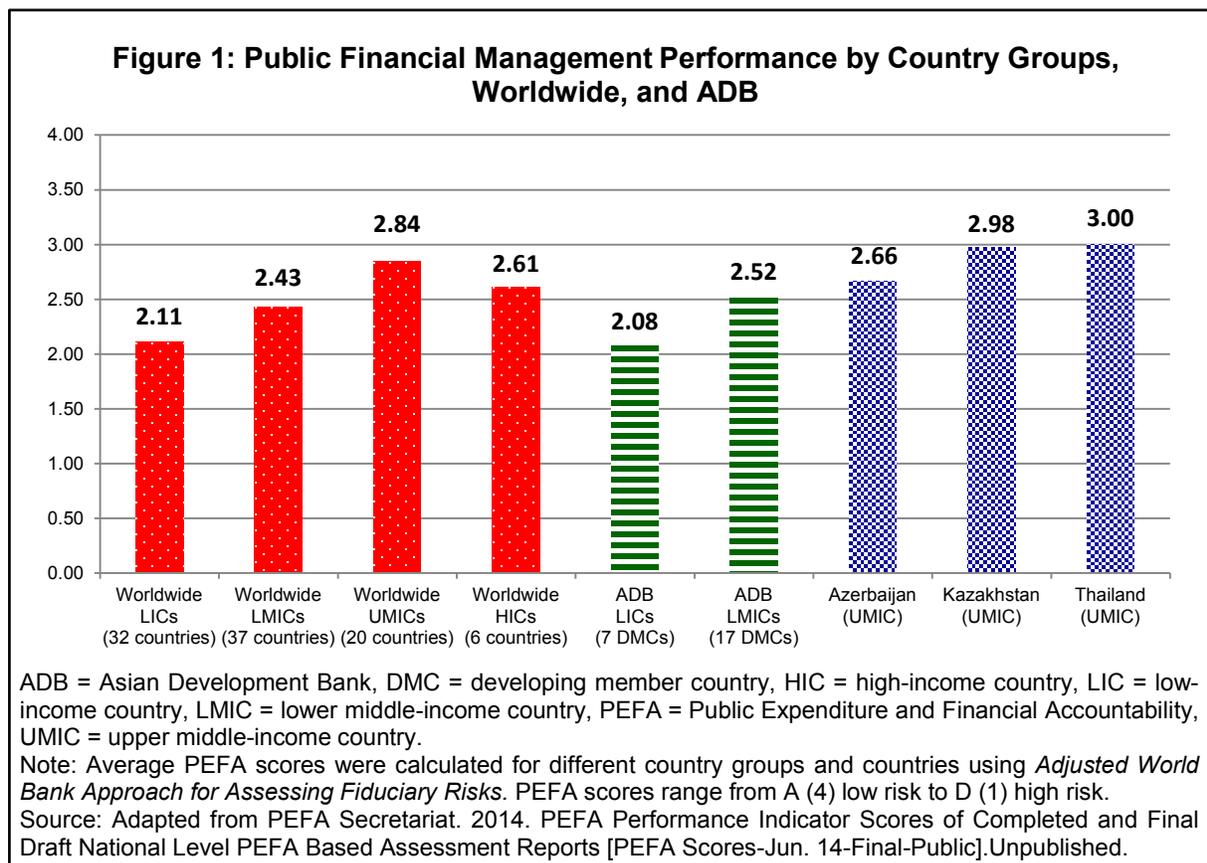
10. While the six UMICs have diverse economic and social development status, important similarities exist. Following decades of strong economic growth, these UMICs have achieved high per-capita incomes and strong human development. They have generally pursued fairly sound economic policies and trading practices. All these countries (except Turkmenistan) have high credit ratings. UMICs also rank higher than lower middle-income countries (LMICs) and low-income countries (LICs) in the quality of their institutions (footnote 2).

11. **Public financial management performance.** Analysis of worldwide Public Expenditure and Financial Accountability (PEFA) scores—as a proxy for PFM performance—shows that PFM performance tends to improve with country income levels (Figure 1).⁹ UMICs as a group had a higher average PEFA score (2.84 out of 4.00) as compared to that of LMICs (2.43) and LICs (2.11).¹⁰ A similar pattern is observed for ADB DMCs. Three of the six ADB UMICs where such assessments have been undertaken (Azerbaijan, Kazakhstan, and Thailand) show higher PFM performance than ADB LICs and LMICs as a group, as well as the corresponding

⁹ The PEFA program assesses the condition of country public expenditure, procurement, and financial accountability systems. Of the 93 countries worldwide for which PEFA scores are publicly available, 24 are ADB DMCs. The PEFA scores for an additional two DMCs (Azerbaijan and Kazakhstan) are not publically available, but were obtained separately.

¹⁰ The use of PEFA scores to compare the relative strength of country PFM systems should be treated with caution. PEFA was designed to compare a country's performance over time and identify areas that need attention. However, in this paper these scores have been used to emphasize that UMICs as a group have better country PFM systems than that of other country groups. Further, available data (not presented here) show that UMICs (worldwide) as a group also perform better on all six PEFA dimensions than LICs and LMICs. However, there are aberrations to this conclusion—six out of 20 worldwide UMICs have a lower overall PEFA score than the LMIC worldwide average.

worldwide scores. PEFA assessments for most of the other ADB UMICs are not available (Appendix 1).



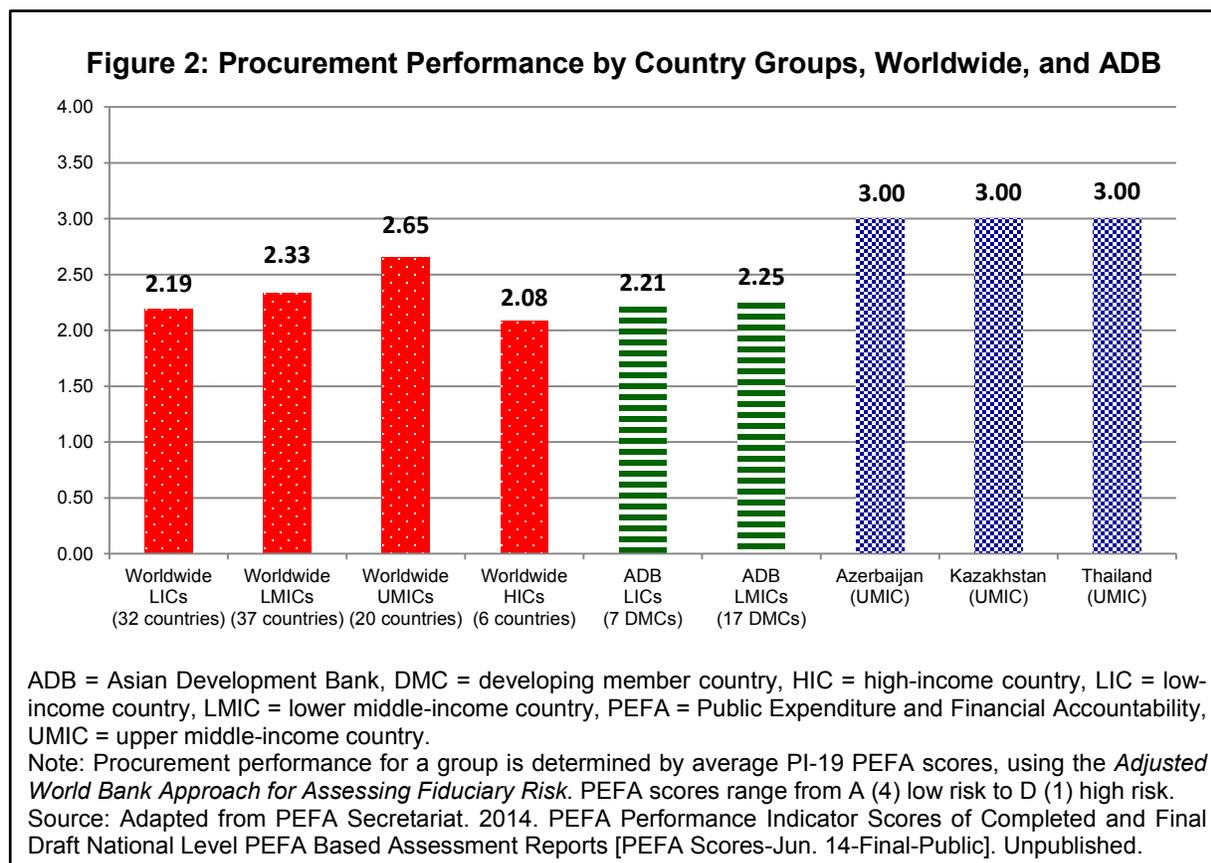
12. **Procurement performance.** Worldwide procurement risk ratings based on the PEFA-related procurement indicator (PI-19) show that procurement performance (average procurement score) tends to improve with country income, from an average of 2.19 in worldwide LICs to 2.65 in UMICs.¹¹ All three ADB UMICs (Azerbaijan, Kazakhstan, and Thailand) for which data are available are rated as having procurement systems associated with medium risk, against a rating of substantial risk for ADB's LICs and LMICs groups (Figure 2).

13. While PI-19 alone is not a comprehensive indicator of a country's procurement performance, it does provide a consistent comparable data set for many countries. Country procurement assessment reports (CPARs)—based on the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD-DAC) Methodology for the Assessment of Procurement Systems (MAPS)—are limited.¹² A CPAR was only conducted in two (Azerbaijan and Kazakhstan) of the six UMICs, and only one of the reports (Kazakhstan)

¹¹ PI-19 of the PEFA framework covers competition, value for money, and controls in procurement. The PI-19 scores of 19 UMICs in the worldwide data set vary widely from 1.5 for South Africa (2008) to 4.0 for Mauritius (2011). Some UMICs had lower PI-19 scores than the average for LMICs. Therefore, a direct correlation between procurement performance and country income levels cannot be presumed.

¹² MAPS assesses public procurement systems based on four pillars: (i) legislative and regulatory framework, (ii) institutional framework and management capacity, (iii) procurement operations and market practices, and (iv) integrity and transparency. It uses 12 indicators and 54 sub-indicators.

is publicly available. Moreover, these reports are more than 6 years old.¹³ Appendix 1 lists the CPARs for ADB DMCs.



14. **Variable risk ratings.** The six upper middle-income countries' performance on risk ratings varies widely. Given the limited availability of standard procurement and PFM assessments,¹⁴ a more detailed country analysis based on other available documentation (including ADB's country and sector level governance risk assessments) is in Appendix 2. Based on these analyses, the following preliminary conclusions can be reached on the PFM and procurement risk ratings of the six UMICs. The PRC, Kazakhstan, Malaysia, and Thailand have PFM and procurement systems that are associated with moderate to medium risk, while the systems of Azerbaijan and Turkmenistan are associated with substantial to high risk (Table 1).¹⁵ ADB does not have any sovereign operations in Malaysia and Thailand, but it will consider a systematic move toward the use of country systems in the PRC and Kazakhstan (selected

¹³ Fifteen of the 20 CPARs for ADB DMCs are more than 5 years old. In cases where CPARs have been carried out, robust analysis or reports based on these CPARs are not publicly available.

¹⁴ Ideally, more recent PEFA assessments and CPARs should have been undertaken and made publicly available for all six UMICs to provide robust evidence on the strength of country systems, and to enable a decision on the possibility of partial or complete use of country PFM and procurement systems in these DMCs.

¹⁵ ADB. 2014. *Procurement Reform – 10 Point Action Plan: New Staff Instruction and Revised Project Administration Instructions 3.01–3.12*. Manila (memorandum issued by Operations Services and Financial Management Department on 22 July). Note that Azerbaijan's procurement risk is rated high in ADB preliminary ratings and medium according to PI-19.

UMICs), given their current risk profile. More systematic diagnostics will be undertaken in these DMCs, given the limited availability of standard governance assessments of their systems.¹⁶

Table 1: Preliminary Risk Ratings of Six Upper Middle-Income Countries on Public Financial Management and Procurement Systems

	Public Financial Management	Procurement
Azerbaijan	Moderate–substantial risk (2008)	High risk
People’s Republic of China	No PEFA assessment (likely moderate risk)	Medium risk
Kazakhstan	Moderate risk (2011)	Medium risk
Malaysia	No PEFA assessment (Likely moderate risk)	Medium risk
Thailand	Moderate risk (2009)	Medium risk
Turkmenistan	No PEFA assessment (likely substantial–high risk)	High risk

PEFA = public expenditure and financial accountability.

Note: Public financial management (PFM) ratings are based on PEFA assessments in the year mentioned. In the case of the People’s Republic of China, Malaysia, and Turkmenistan, all of which had no PEFA assessments, the risk ratings are based on information from other sources including Asian Development Bank governance assessments and global governance indicators. The ratings in parenthesis, therefore, reflect ADB’s judgment.

Sources: For PFM ratings: PEFA Secretariat. 2014. PEFA Performance Indicator Scores of Completed and Final Draft National Level PEFA Based Assessment Reports [PEFA Scores-Jun. 14-Final-Public]. Unpublished; for procurement ratings: Asian Development Bank. 2014. Operations Services and Financial Management Department memo dated 22 July. High risk signifies a less developed procurement system; medium procurement risk refers to a developing procurement system.

B. Governance Risk Assessments of ADB’s Developing Member Countries

15. **Governance diagnostics.** Existing governance risk assessments and risk management plans (RAMPs) of DMCs prepared by ADB, including those available for the six UMICs, suggest a lack of rigorous analyses on the strength of country procurement and PFM systems. Such assessments neither identify the risks of using country systems, nor the dimensions of country PFM and procurement systems that can be relied on.¹⁷ Project level RAMPs also narrowly focus on fiduciary risks that may lead to suboptimal use of ADB resources. Country partnership strategies (CPSs) and the project documents do not systematically present the results of governance assessments or the risks to the use of country systems in ADB’s operations (Appendix 2).

16. Lack of availability of robust governance assessments and analyses in most ADB documents could be due to many reasons, including the lack of systematic focus on institutional development and use of country systems, suboptimal diagnostic tools and implementation guidelines, and inadequate implementation of guidelines on the use of country systems. To consider the use of country systems in its DMCs more systematically, ADB needs to identify constraints and agree on actions to address these. The results of governance assessments (at country, sector, and project levels) can be a powerful source for monitoring progress on the strength of country systems or agency capacities over time, if staff systematically compile and analyze such information. Such analyses are necessary to guide staff to make a judgment on

¹⁶ Of the two standard governance assessments (PEFA and CPAR), only one of the six UMICs (Thailand) had a publicly available PEFA and only one DMC (Kazakhstan) had a publicly available CPAR (Appendix 1).

¹⁷ The country-level governance RAMPs available for the three UMICs (Azerbaijan, Kazakhstan, and Thailand) include reviews of their PFM and procurement systems, including national-level anticorruption measures, but do not assess risks for their use in ADB projects (Appendix 2).

where the use of country systems may be possible and to document dimensions in which country systems are already in use.

17. ADB monitors the use of country systems but a more systematic approach is required to achieve sustained improvement. Recognizing its commitments to international aid effectiveness declarations, ADB has been monitoring the use of country PFM and procurement systems through its annual Development Effectiveness reports, since 2013.¹⁸ According to the latest information, the use of country procurement systems decreased substantially from 48% in 2012 to 33% in 2013 for ADB operations; and the use of country PFM systems in ADB operations decreased from 70% in 2012 to 67% in 2013. ADB's use of country PFM and procurement systems varies widely in the six UMICs. Its use of the PRC's country procurement systems declined from 48% in 2012 to 32% in 2013, while it recorded 100% use of the PRC's PFM systems in both years.¹⁹ In most other UMICs, use of country systems was minimal (less than 1%).

18. ADB's performance on the use of country systems can vary unpredictably from year to year, since the measure is based on the nature of ADB modalities and the size of procurement contracts used in ADB's sovereign lending operations in these countries. Higher use of budget support modalities and smaller contract sizes, for which national competitive bidding (NCB) procedures are used, leads to better performance on the use of country procurement systems.²⁰ To achieve sustained improvement in the performance of ADB on the use of country systems, a more systematic approach will be required to undertaking robust assessments and to the use of country systems.

C. Does ADB's Procurement Policy Facilitate the Use of Country Systems?

19. **ADB's procurement policy constraint.** ADB's Procurement Guidelines (procurement policy), approved by ADB's Board of Directors, state that ADB's procurement guidelines and procedures will "apply to all contracts for goods and works financed in whole or in part by ADB."²¹ The policy allows for the use of country systems in NCB procedures for public procurement in a DMC, specifying that country procedures may be used if they ensure economy, efficiency, and transparency; and if they are broadly consistent with ADB's procurement rules.²² However, strict adherence to detailed ADB procedures is required for international competitive bidding (ICB). The issue of the use of country procurement systems therefore pertains to the flexibility of such use in ICB, and this will require an amendment in ADB's procurement policy.²³

¹⁸ ADB. 2014. *Development Effectiveness Review Report 2013*. Manila.

¹⁹ The decline in ADB's use of country procurement systems in the PRC is primarily due to a much larger size of procurement contracts used in ADB operations, for which international competitive bidding (ICB) procedures were used (and therefore a decline in the value of contracts that used national competitive bidding [NCB]).

²⁰ ADB uses a modified version of the OECD-DAC definition of the use of country systems in its corporate results framework. For use of procurement systems, it includes the value of contracts through NCB and those through its budget support modalities and contracts through financial intermediaries. For use of country PFM systems, ADB's indicator covers only one component (use of a country's auditing procedures) compared with three indicators used by the OECD-DAC for global monitoring reports on aid effectiveness (use of national budget execution, financial reporting, and auditing procedures). See Appendix 5.

²¹ ADB. 2013. *Procurement Guidelines*. Manila (para. 1.5).

²² ADB. 2013. *Procurement Guidelines*. Manila (para. 3.3).

²³ ADB considers contracts through NCB as use of country systems. However, since these systems are assessed and ADB puts additional requirements (NCB Annex) to ensure consistency with ADB's procurement rules, this is strictly not use of country systems according to the OECD-DAC's definition—only NCB without additional ADB requirements qualifies. Therefore, ADB's efforts to improve the use of country systems should also aim to reduce the number of requirements and conditions in NCB Annexes over time.

20. **More robust procurement diagnostic tools developed.** Recognizing the need to improve country, sector, and project level procurement risk analysis, ADB issued new staff guidelines in August 2014 on undertaking robust procurement assessments that are consistent with the MAPS methodology.²⁴ The assessments to be carried out during CPS preparation (i.e., procurement risk and risk management plans) intend to (i) identify risks that for country, sector, agency, or project systems and/or practices could result in suboptimal use of ADB resources (ii) assess the severity of the risk; and (iii) develop a practical risk management plan to address risks that could adversely impact project implementation and/or achievement of project outcomes. The resulting risk assessments will gradually replace the preliminary procurement risk ratings agreed by ADB for its DMCs. These guidelines, however, do not explicitly encourage or require staff to engage in discussions on the use of country systems at the country level or to identify risks associated with using country systems.

21. **Evolution in ADB's approach and recent procurement reform measures.** While ADB does not have an explicit approach to the use of country procurement or PFM systems, it has taken a number of steps that are likely to result in increased use of country systems in ADB's project lending operations. It has introduced instruments and modalities, e.g., its results-based lending (RBL) modality of support to DMCs, which allows for upstream discussion on reforms and DMCs' implementation capacity; and accepts the use of country program systems in such operations.²⁵ In its policy-based lending modality also, ADB allows for the use of country systems.

22. Recent measures, based on a 10-point procurement reform action plan adopted in July 2014, introduced a risk-based approach that provides more flexibility in procedures and quicker approval processes for procurement on ADB projects in DMCs considered low-risk (footnote 15). UMICs with low to medium risk ratings (with higher ICB thresholds: the PRC, \$40 million; Malaysia and Thailand, \$25 million; and Kazakhstan, \$10 million) will benefit from the new system, which allows NCB to be used more widely.²⁶ Below these thresholds, NCB will be applied where country systems are used.

23. ADB has also raised thresholds for prior reviews,²⁷ and proposed greater reliance on post review of contracts. UMICs with a medium procurement risk rating (including, Kazakhstan, Malaysia, and Thailand) will have a higher prior review threshold (\$10 million) and greater reliance on post reviews.²⁸ ADB will therefore be relying on the government to take procurement decisions and use country systems for contracts (works/plants/goods) below this threshold, reflecting increased focus on DMCs' capacity to administer procurement at both project and national levels.

24. **New procurement measures.** The measures to increase ICB thresholds and the introduction of a new post review procurement supervision approach are likely to increase the

²⁴ ADB. 2014. *Guide on Assessing Procurement Risks and Determining Project Procurement Classification*. Manila.

²⁵ ADB. 2013. *Piloting Results-Based Lending for Programs*. Manila.

²⁶ The ICB threshold is \$5 million for Azerbaijan and \$3 million for Turkmenistan.

²⁷ ADB. 2014. Preparatory Work for Procurement. *Project Administration Instructions*. PAI 3.02. Manila (para. 22). Prior review is where ADB must review the procurement process and provide a no-objection before the process proceeds.

²⁸ ADB will do post review on a sample basis for procurement of any contract valued at less than \$5 million. This is the same threshold for all DMCs with higher risk procurements, including Azerbaijan and Turkmenistan. The decision on granting post review will be based on the assessment of the executing agency's capacity to take greater procurement responsibility. Under post review, the executing agency approves the award and ADB will post review only a sample of contracts awarded (PAI 3.02, para. 48).

use of country systems in UMICs (and in ADB's overall operations). In addition, undertaking country, sector, and agency procurement risk assessments will increase ADB's understanding of the capacity and maturity of DMC procurement systems and enable the provision of more focused capacity building support. The proposed comprehensive procurement plan to be prepared by the executing agencies for each project will provide details of the prior review, post review, and supervisory arrangements initially determined in the procurement risk assessments (footnote 27). Furthermore, ADB will review its procurement policy in 2015 to consider removal of the policy constraint to the use of country procurement systems in ADB's investment lending operations (footnote 21).

D. Does ADB's Governance Strategic Framework Promote the Use of Country Systems?

25. **ADB's strategic governance framework.** The framework allows for the use of country systems. ADB's 2006 Second Governance and Anticorruption Action Plan (GACAP II), which is ADB's strategic framework on mainstreaming governance and anticorruption in its operations, emphasizes ADB's commitment to increased alignment with country priorities and systems.²⁹ In managing governance and corruption risks using a risk-based approach, GACAP II noted that country teams and DMCs were to jointly review and report on the implementation and outcomes of PFM, procurement, and corruption risk management plans,³⁰ and that country portfolio review missions should routinely review and report on country systems.³¹ One of the priority compliance actions for the delivery of governance, institutional, and anticorruption programs at the country level is that country teams are to "establish in consultation with DMCs, mutually acceptable performance criteria for moving to country procurement and PFM systems," and the underlying assumption is that "ADB will rely on partner country systems for procurement and PFM when the DMC has implemented mutually agreed standards and processes."³²

26. **Governance assessments inadequate.** The 2011 staff guidance for operationalizing GACAP II—ADB's 2011 Revised Guidelines for Implementing GACAP II—stipulated that sector-level risk assessments should look for evidence of risks in country systems and at risks arising from ADB-specified systems (given the distinctiveness of the two sets of systems). While the guidelines emphasized that ADB's partnerships with DMCs should strengthen country systems and actions to reduce vulnerability to corruption in ADB investments, it did not explicitly require staff to assess the suitability of such country systems for their use in ADB operations.³³

27. Available governance risk assessments (which are based on the 2011 staff guidance) do not assess and analyze the readiness of country PFM or procurement systems for their use in ADB operations. Thus, GACAP II implementation has two gaps related to the use of country systems:

- (i) Between the GACAP II strategic framework and the implementation guidelines: while ADB's policy framework emphasizes the alignment of ADB's assistance

²⁹ ADB. 2006. *Second Governance and Anticorruption Action Plan (GACAP II)*. Final Report. Manila (pp. 8–9).

³⁰ Governance risk and management plans are instruments through which governance risks and mitigation measures in all the three thematic areas of GACAP II are identified. Risks are assessed at national and/or subnational, sector, and project level.

³¹ Footnote 29. Appendix 1. pp. 8, 9, and 20.

³² ADB. 2006. *Second Governance and Anticorruption Action Plan (GACAP II)*. Final Report. Manila (Appendix 1. Action Point 2.4. p. 20).

³³ ADB. 2011. *Revised Guidelines for Implementing ADB's Second Governance and Anticorruption Action Plan (GACAP II)*. Manila (pp. 1–2). Assessing whether and how to use country systems is not, for example, mentioned on p. 2 or in the three model terms of reference for country, sector, and project assessments.

with DMC country systems, this was not fully reflected in the 2011 implementation guidelines. The associated tools to implement the guidelines are also inadequate for systematic alignment with or use of country systems.

- (ii) Between the implementation guidelines and actual practice: while implementation guidelines at the sector level required separate risk assessments and risk management plans for country systems and ADB projects systems, this was not generally adhered to. Reviews of procurement and PFM systems as well as the anticorruption measures of DMC governments' systems compared with ADB project systems, are not generally included in RAMP summary risk matrices and risk management plans at any level (country, sector, or project). The report and recommendation of the President and linked documents for ADB project lending operations are not required to assess the extent and use of country procurement and PFM systems systematically (para 15).

28. A recent independent evaluation study also confirmed that the quality of the country and sector governance RAMPs needs to be improved.³⁴ Staff guidance for the implementation of GACAP II needs to include measures to strengthen the quality of RAMPs. To systematically promote the use of country procurement and PFM systems in ADB operations, actions need to be taken both in improving the relevant diagnostic tools and staff guidelines, and in implementing these guidelines better to conduct robust assessments and analyses. Staff needs to do better analyses and make a professional judgment on the risks from the use of country systems.

29. **Revise and implement guidelines.** ADB's guidelines for implementing GACAP II, which until recently did not reflect ADB's strategic focus on greater alignment with and use of country systems, were revised in December 2014.³⁵ Under the new revised guidelines, comprehensive governance risk assessments and risk management plans will be ADB's primary instruments for assessing the risks and benefits of using country procurement and PFM systems. GACAP II new guidelines will complement ADB's guidelines on assessing procurement risks (footnote 24), and assess the suitability of and risks related to the use of country procurement and PFM systems, and DMC implementation capacity.

30. More robust governance and procurement risk assessments based on ADB's new GACAP II guidelines will improve the quality of risk assessments and risk management plans, and document analyses to identify risks in using country systems. Such assessments, combined with project level assessments, will also allow ADB to determine constraints in ADB's use of country procurement and PFM systems at the country and agency level, and help ADB distinguish elements of country systems that it can use and those that require further strengthening.

IV. USE OF COUNTRY SAFEGUARD SYSTEMS IN UPPER MIDDLE-INCOME COUNTRIES

31. Country safeguard systems cover environmental assessment, involuntary resettlement, and indigenous peoples; and are seen as a cornerstone of socially inclusive and

³⁴ Independent Evaluation Department. 2014. *Thematic Evaluation Study: ADB support for Enhancing Governance in its Public Sector Operations*. Manila: ADB.

³⁵ ADB. 2014. *Revised Staff Guidance for Implementing the Second Governance and Anticorruption Action Plan (GACAP II): Assessing and Managing Governance Risks in ADB Operations*. Manila.

environmentally sustainable growth. Country safeguards refer to the legal and institutional framework of a country, consisting of its national, subnational, or sector implementing institutions and relevant laws; regulations; and rules and procedures that seek to avoid, minimize, or mitigate adverse environmental impacts, social costs to third parties, or marginalization of vulnerable groups that may result from development activities.

32. **ADB's Safeguard Policy Statement.** The Safeguard Policy Statement (SPS, 2009) commits ADB to strengthen DMCs' country safeguard systems in the areas of environmental assessment, involuntary resettlement, and indigenous people, and allows for the use of country safeguard systems.³⁶ The policy recognizes that DMCs have their own systems for delivering safeguards, and that supporting DMCs' efforts to strengthen and use their own systems would enhance country ownership, improve efficiency, and reduce transaction costs.

33. ADB's policy allows for the use of country safeguard systems subject to the DMCs meeting the dual tests of equivalence and acceptability in relation to the SPS policy principles. Equivalence assessments determine if DMCs' legal provisions and domestic policy requirements are equivalent to SPS policy principles; and acceptability assessments establish whether the DMC and/or agency has the capacity to implement its own applicable laws, regulations, rules, and procedures, keeping in view its track record in implementing existing country safeguard systems. In both cases, gaps may exist between a country's legal requirements and the corresponding SPS policy principles and/or between a country's legal requirements and its capacity and commitment to implement those requirements. In such cases, the SPS requires gap-filling measures to be implemented through ADB operations by which the country may attain full equivalence and acceptability to use country systems (in one or more of ADB's three safeguards).³⁷

34. **Status on country safeguard systems.** Provisional results of rapid equivalence assessments of the six UMICs (Azerbaijan, the PRC, Kazakhstan, Malaysia, Thailand, and Turkmenistan) on each of three safeguards (i.e., environmental, involuntary resettlement, and indigenous peoples) are discussed below (paras. 35 to 37).³⁸ All six DMCs' systems were reviewed with respect to ADB's policy principles on each of the three safeguards. On indigenous peoples, the rapid assessments were limited to the PRC, Malaysia, and Thailand since no indigenous peoples categories are recognized by the governments of the three Central Asian UMICs or by any international organization, such as the United Nations Forum on Indigenous Peoples, for these countries.

35. **Environmental safeguards.** Preliminary results of the rapid equivalence assessments on environmental safeguards show diversity in the six DMCs' achievements against the requirements of 11 SPS principles (Figure 3).³⁹

³⁶ ADB. 2009. *Safeguard Policy Statement*. Manila.

³⁷ Footnote 36. ADB's SPS emphasizes the need to "ensure that ADB's safeguard principles are not compromised and that risks associated with country safeguard systems are managed." ADB. 2009. *Safeguards Policy Statement*. Manila (p.12, para. 37).

³⁸ Rapid equivalence assessments of the six UMICs were undertaken during August–September 2014 through consultancy inputs supervised jointly by ADB's Strategy and Policy Department and the Regional and Sustainable Development Department. This mapping exercise did not include an acceptability assessment; such an assessment would need to be conducted at a later stage at DMC and/or sector and/or agency level to satisfy the requirement of ADB's SPS.

³⁹ Rapid assessments were undertaken against all the 28 elements of the 11 policy principles of ADB's SPS. However, results from these rapid assessments may need to be confirmed through more detailed assessments in some cases.

- (i) The PRC shows full or partial equivalence on all the policy principles except on the requirement of consultation and establishment of a grievance redress mechanism (policy principle 5). The PRC's law or enforcement rules do not contain any details on a grievance redress mechanism.
- (ii) Kazakhstan shows full or partial equivalence between its country legal and policy framework and that required by ADB policy on all 11 principles; no principle had "no equivalence."
- (iii) Malaysia shows full or partial equivalence in several policy principles except on the requirements of environmental assessment (policy principle 2), alternatives examination (policy principle 3), consultation and a grievance redress mechanism (policy principle 5), and information disclosure (policy principle 6). Thailand shows full or partial equivalence on most SPS principles, except in some requirements of environmental assessment (policy principle 4), and consultation and a grievance redress mechanism (policy principle 5).
- (iv) Azerbaijan and Turkmenistan also show partial or full equivalence on some principles, but show no equivalence on other important policy principles, including the requirements of consultation and a grievance redress mechanism (policy principle 5) and on disclosure of information on environmental assessments (policy principle 6).

36. **Involuntary resettlement.**⁴⁰ The results of the rapid equivalence assessments for the six UMICs indicate significant gaps between ADB policy standards on involuntary resettlement safeguards and country legal framework and systems. Each country has full equivalence on only one or two principles, and no equivalence for the rest of the principles. The PRC, despite many decades of borrowing experience, is only fully equivalent with one policy principle—that compensation is paid and other resettlement entitlements are provided before physical or economic displacement.

37. **Indigenous peoples.**⁴¹ For the three DMCs (the PRC, Malaysia, and Thailand) assessed for equivalence between their national laws against indigenous peoples principles under ADB's SPS, the results show significant gaps. Full equivalence did not exist on any principle or elements thereof. All three DMCs had no equivalence on most of the policy principles and their elements against ADB's policy requirements on indigenous peoples.

⁴⁰ Involuntary resettlement safeguards include 12 policy principles according to ADB's policy.

⁴¹ Indigenous peoples safeguards include nine policy principles according to ADB's policy.

Figure 3: Results of Equivalence Assessments on Environmental Safeguards

Environmental Safeguards						
Policy Principles	AZE	PRC	KAZ	MAL	THA	TKM
1. Project screening and categorization	Full	Full	Full	Full	Full	Full
2. Environmental assessment	Partial	Full	Full	Partial	Partial	Full
3. Alternatives examination	No	Full	Full	No	Full	Full
4. Environmental management plan	Full	Full	Full	Full	Full	Full
5. Consultation and grievance redress mechanism	No	Partial	Full	Partial	Partial	No
6. Information disclosure	No	Full	Full	No	Full	No
7. Monitoring and reporting	Full	Full	Full	Full	Full	Full
8. Biodiversity protection and natural resources management	Full	Full	Full	Full	Full	Full
9. Pollution prevention and abatement	Full	Full	Full	Full	Full	Full
10. Occupational and community health and safety	Full	Full	Full	Full	Full	Full
11. Physical cultural resources	Full	Full	Full	Full	Full	Full

Legend:

Full Equivalence	Green grid pattern
Partial Equivalence	Orange horizontal lines
No Equivalence	Red vertical lines

AZE = Azerbaijan, PRC = People's Republic of China, KAZ = Kazakhstan, MAL = Malaysia, THA = Thailand, TKM = Turkmenistan.

Source: Asian Development Bank staff assessments.

38. **Consider use of environmental safeguards.** From the analysis based on the rapid assessments of the six UMICs (paras. 35–37), it is evident that a universal approach to the use of country safeguard systems, and for all UMICs as a group, is not possible in the short term. Recognizing the progress made on strengthening their environmental policies and legal frameworks, ADB will fast-track dialogue on the possible use of country environmental safeguard systems in two of the six UMICs considered in this paper—the PRC and Kazakhstan—subject to initial acceptability assessments to establish the track record and capacity in delivering country environmental safeguard systems in key sectors, and based on the demand by these DMCs to use their own systems.⁴² In DMCs, such as the PRC, where ADB operations may increasingly be in lagging and remote regions, country teams may have to adapt the approach, as local government capacity and systems may be weak.

39. **Limited potential on involuntary resettlement and indigenous peoples.** Given significant gaps in the six UMICs' national laws and respective principles of ADB policy on

⁴² Malaysia and Thailand are not being considered since ADB does not have sovereign operations in these DMCs. If this position changes in the future, these countries can be considered.

involuntary resettlement and indigenous peoples, ADB will not explore the use of these systems in ADB's investment lending operations in the short term.

V. ADB'S FRAMEWORK TO PROMOTE THE USE OF COUNTRY SYSTEMS

40. Need for a **context-specific approach**. Preliminary analysis based on available assessments (presented in paras. 10 to 39) suggests that:

- (i) The six UMICs vary widely in terms of the strength of their country systems, so it is not feasible to consider the use of country systems based on an exclusive approach for all UMICs as a group (Box 1). A context-specific approach, which is consistent with the capacities and strengths of these systems in ADB DMCs, is required.
- (ii) The PRC and Kazakhstan have relatively well-functioning procurement, PFM and environmental safeguard systems, so ADB can consider them for implementing its systematic approach to the use of their country systems.
- (iii) Significant gaps exist in the selected UMICs' national laws and respective principles of ADB policy on involuntary resettlement and indigenous peoples, so the use of these two systems in ADB operations will not be explored in Phase 1. ADB will only consider the use of environmental safeguards in the selected DMCs.

Box 1: Differences among Upper Middle-Income Countries on Country Systems

Procurement. The People's Republic of China (PRC), Kazakhstan, Malaysia, and Thailand have procurement systems that are associated with medium risk, while the systems of Azerbaijan and Turkmenistan are associated with high risk.

Public financial management. The PRC, Kazakhstan, Malaysia, and Thailand have public financial management (PFM) systems that are associated with moderate risk, Azerbaijan's PFM system with moderate-high risk, while that of Turkmenistan with high-substantial risk.

Environmental policy principles. The PRC, Kazakhstan, and Thailand show fuller equivalence between their country legal and policy framework and that required by Asian Development Bank (ADB) policy. Azerbaijan, Malaysia, and Turkmenistan also show full or partial equivalence on some principles, but no equivalence on several other important policy principles (including the requirement on disclosure of information).

Involuntary resettlement. For all six upper middle-income countries, equivalence assessments suggest significant gaps between national legal frameworks and systems and ADB's policy standards.

Indigenous peoples. The national laws of the PRC, Malaysia, and Thailand show significant gaps with ADB's policy on indigenous peoples. No categories of such groups are recognized in Azerbaijan, Kazakhstan, and Turkmenistan.

Source: ADB staff assessments.

41. Review of ADB's diagnostic tools and the results of available assessments on all three country systems in the six UMICs suggest that ADB has not implemented a systematic approach to promoting the use of country systems in its investment lending operations. Governance risk assessment diagnostic guidelines and tools are not explicit in the focus on the use of country systems, and the quality of governance RAMPs requires strengthening. Available

RAMPs do not critically assess the strength of country PFM and procurement systems against ADB required standards, or identify actions for their possible use in ADB operations.

42. In the case of safeguards systems, while ADB policy and assessment tools are adequate, and ADB is undertaking equivalence assessments to identify gaps between the DMCs' systems and ADB's safeguard requirements, rigorous analysis on the suitability and use of country safeguards systems in ADB operations has not yet been undertaken.⁴³ ADB needs to fast-track such analyses, assess the possibility of the use of country environmental safeguard systems in ADB investment lending operations, and conduct strategic discussions with its DMCs on the use of these systems.

43. **Experience of other multilateral development banks.** ADB has kept in view the experience of other multilateral development banks (MDBs) in formulating its approach to the use of country systems in its operations. The World Bank implemented a pilot program on the use of country procurement systems during 2008–2010.⁴⁴ The program, which covered 20 of its client countries, was not considered successful for a number of reasons, including lack of understanding on the complexity of issues, and unrealistic expectations on the speed of implementation, both on the part of World Bank staff and the client countries. The World Bank pilot program highlighted the need for all stakeholders to have reasonable expectations on the speed of implementation, and to understand that only a gradual shift is possible given the complexity involved in the use of country systems, with implementation based on learning by doing. Learning from the World Bank's experience, and recognizing the complexity of the governance and safeguards agenda in its operations, ADB will take a phased approach to the use of country systems. ADB will also keep in view evolving approaches of the World Bank on country procurement and safeguard systems (summarized in paras. 56 and 57, and Box 2).

44. **ADB will take a phased approach.** Under the Phase 1 (2015–2017), ADB will systematically consider the use of country systems in the PRC and Kazakhstan, and will broaden the sample to include four other DMCs considered to have well-functioning internal systems to have more robust evidence from implementing Phase 1. These four DMCs are Fiji, India, Indonesia, and Sri Lanka, all of which have overall low to medium governance risk ratings. The six pilot DMCs of Phase 1 provide a good geographical spread across different regional departments of ADB.⁴⁵

45. The actual use of country systems, however, will continue to depend on the DMCs' preferences for using ADB's or their own systems, and their institutional capacities at national or subnational government levels. Furthermore, in DMCs where ADB's operational focus is toward lagging and remote regions, e.g., in the PRC, ADB may need to adapt its approach, since these regions may have weaker systems and implementing agencies may lack capacity and experience. Whether ADB implements the country systems framework in all three or fewer systems in Phase 1 will depend on the country context and the results of specific country systems assessments.

⁴³ ADB. 2010. *Technical Assistance for the Strengthening and Use of Country Safeguard Systems*. Manila. Through this technical assistance project, ADB is supporting equivalence assessments and providing support to build DMCs' legal frameworks and safeguard systems.

⁴⁴ World Bank. 2010. *Piloting Program in the Use of Country Procurement Systems: Second progress report*. Washington, DC; Inter-American Development Bank. Strategy for Strengthening and Use of Country Systems. Unpublished.

⁴⁵ The sample of DMCs in Phase 1 may change, based on the state of readiness and interest of DMCs.

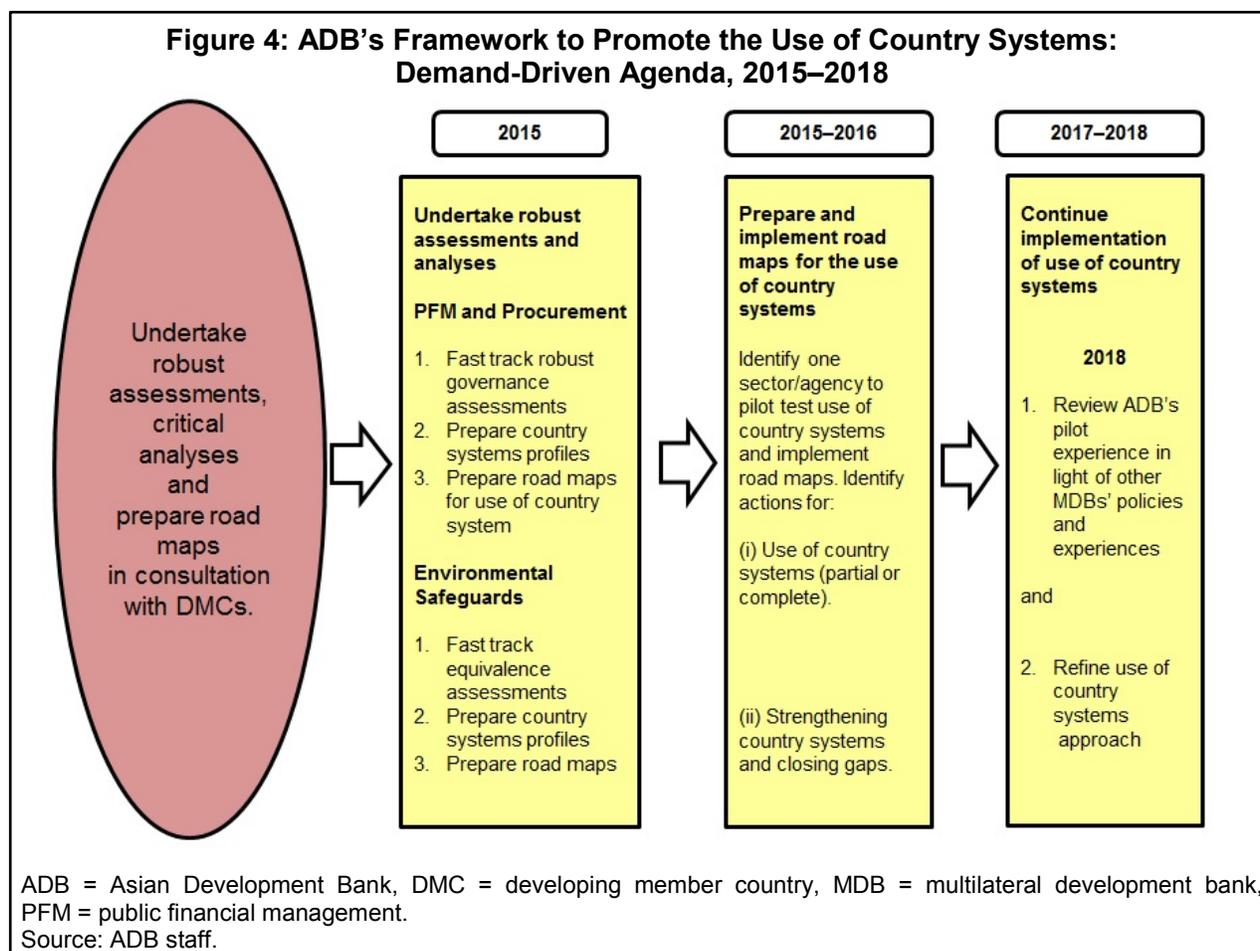
A. Phase 1: ADB's Framework and Actions to Promote the Use of Country Systems, 2015–2017

46. **Undertake robust governance risk assessments and prepare country profiles (2015).** ADB will fast-track governance risk (including procurement risk) assessments in selected Phase 1 DMCs (the PRC, Fiji, India, Indonesia, Kazakhstan, and Sri Lanka) in 2015, based on the new GACAP II guidelines, and the staff guidance on procurement assessment (footnotes 24 and 35). A summary country procurement, and PFM systems profile, based on these assessments, will be prepared for each of the six DMCs. The country profile will include critical analysis on the strength and suitability of country procurement and PFM systems for use in ADB's sovereign project lending operations. The country profiles will also document information on dimensions of procurement and PFM systems where country systems are already being used, e.g., ADB's sovereign projects in the PRC use national auditing procedures in ADB operations (including in investment lending operations).⁴⁶ The proposed ADB framework to promote the use of country systems in its sovereign investment lending operations is summarized in Figure 4.

47. **Undertake environmental systems assessments, and prepare country profiles (2015).** ADB will fast-track environmental systems equivalence assessments and analyses on the six selected DMCs under Phase 1.⁴⁷ Based on the results of the equivalence assessments, ADB will prepare country environmental systems profiles for each of the six DMCs. The country systems profile will include staff's professional judgment on elements of country environmental systems that ADB can rely on for use in its operations, and those where risk mitigation or gap-filling measures will be required if country systems are to be used.

⁴⁶ ADB staff assessments based on the data set used for ADB's Development Effectiveness Review report, 2013 (footnote 18).

⁴⁷ Thailand also qualifies for discussion on the use of its environmental safeguards in ADB operations based on the results of the rapid equivalence assessment. If ADB restarts sovereign operations in Thailand, discussion on the use of country systems can be initiated.



48. **Begin Strategic discussions and prepare road maps (2015–2016).** ADB will begin a systematic dialogue in the six selected DMCs either before or as a part of its CPS discussions, based on the country systems profiles of these DMCs. Country teams will identify a minimum of one sector and/or project and/or agency in each of the six DMCs, in which the use of any or all three country systems could potentially be pilot tested. The sector and or agency would be identified based on the results of strategic discussions and the willingness of DMCs to use their systems, and on project level financial management and procurement assessments and environmental safeguards acceptability assessments.⁴⁸

49. The results of the governance and environmental systems assessments and country systems profiles of each DMC, with staff's professional judgment on the possible use of the three country systems, will be reflected in the country strategy documents as well as specific project documents. Necessary analytical or assessment documents could be prepared at any time, as needed; it is not necessary to undertake these assessments and analyses when preparing the CPSs of these DMCs. Country teams (including procurement, PFM, and safeguard specialists) will prepare a road map on the use of country systems in specific projects of the six DMCs in 2015, with time frames, capacity strengthening requirements, and preferences of each DMC for the use of country systems. The road maps will provide details on the extent of reliance on each dimension of the country systems being considered.

⁴⁸ ADB will begin environmental systems acceptability assessments at the selected agency and project level, based on the willingness of the selected DMCs during Phase 1 (2015–2017).

50. **Approve Road maps for the use of country systems.** Since CPSs will reflect the results of governance and environmental systems assessments and staff's judgment on the possible use of country systems, ADB's Board of Directors will have the opportunity to discuss and endorse the intended use of country systems in selected DMCs at the time of CPS approval, subject to specific due diligence conducted at the project or program level. Project level risk assessments (financial management, procurement, and safeguards) will confirm or modify country level parameters in view of agency capacities and risks associated with the project. The Board will have an opportunity to discuss and endorse the reliance on country systems proposed at the project level.

51. Institutional development and strengthening of systems are an integral part of the move toward the use of country systems. Implementation of the country systems framework and recognition of areas and systems that need gap-filling measures will be a key basis for systematic institutional development of DMCs. ADB will implement its Phase 1 for 3 years to yield sufficient information, and refine its approach in light of this experience and evolving approaches of other MDBs before ultimately mainstreaming this approach in other DMCs.

B. Underlying Actions to Implement the Use of the Country Systems Approach Systematically

52. To adopt a systematic approach (as highlighted in paras. 46–51) and promote the use of country systems in ADB operations, ADB needs to take the following actions (summarized in Figure 5).

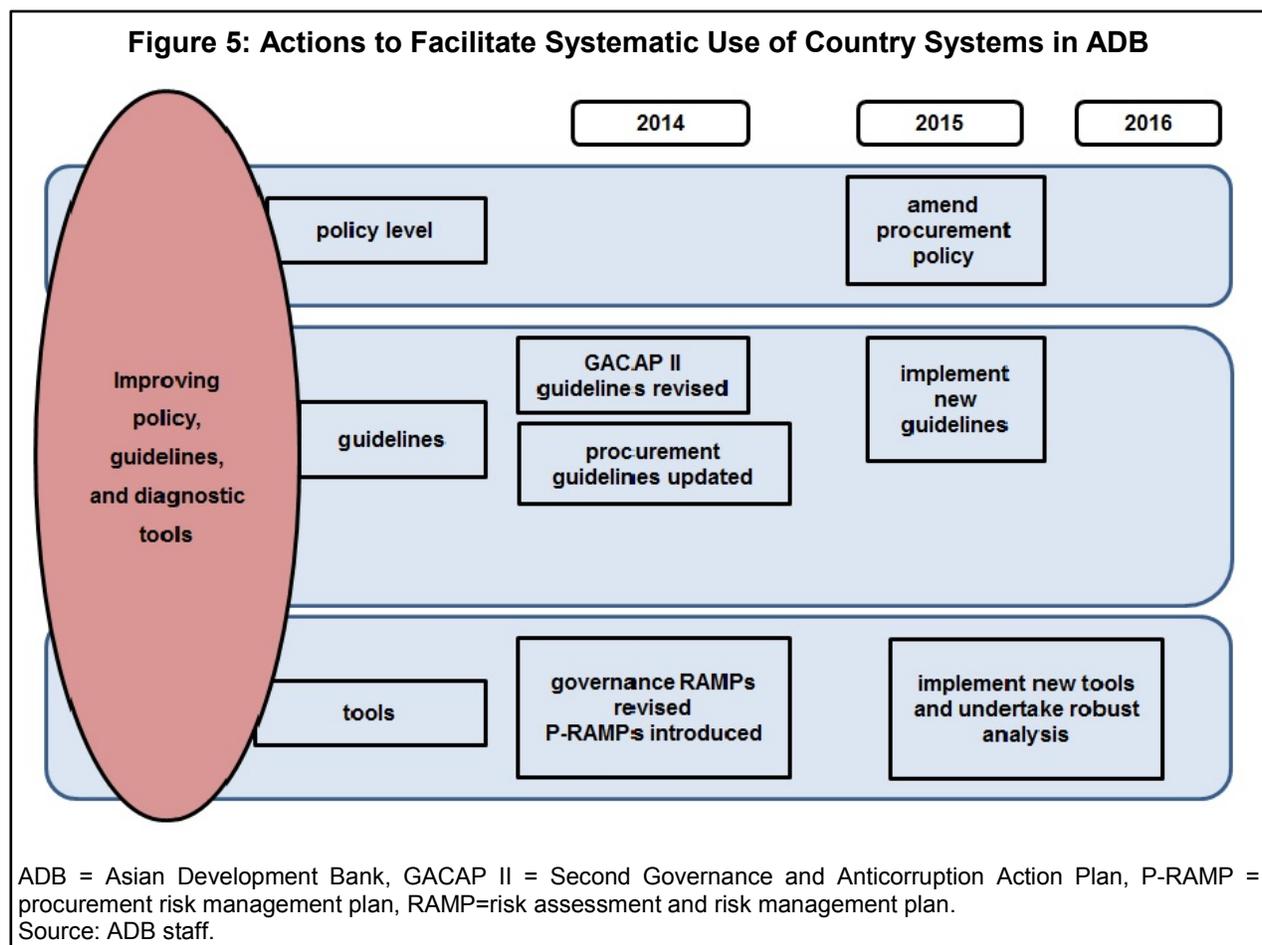
53. **Remove policy impediments.** ADB will review its procurement policy in 2015, and consider amendments to allow the use of country systems in its operations, including its investment lending operations. Actual use of the country systems under the revised policy will be selective based on the country context and results of the country governance risk assessments, ensuring that ADB's broad fiduciary requirements are not compromised. The policy paper will determine the criteria under which such policy flexibility will be considered.⁴⁹

54. **Implement Revised Second Governance and Anticorruption Action Plan guidelines.** Staff guidelines for the implementation of GACAP II, as revised at the end of 2014, which reflect ADB's policy focus on greater alignment with and use of country PFM and procurement systems, will be implemented more rigorously. Ultimately, the implementation of these guidelines and resulting assessments of DMCs will determine the feasibility of use of country systems consistent with the capacities and strengths of PFM and procurement systems in individual countries.

55. **Revise country partnership strategy guidelines.** CPSs will be required to reflect the results of governance risk and environmental assessments, and include a summary of the progress made on strengthening and use of country systems (PFM, procurement, and environmental safeguards) in DMCs. Such documentation will inform strategic consultations on the use of country systems at the country and project level, and help identify gap-filling and institutional development measures. Country partnership guidelines will be revised accordingly. The development of country systems profiles and required analyses can be conducted (by ADB)

⁴⁹ No other policy impediments exist since ADB's governance strategic framework and SPS already allow for the use of country systems.

independently of the CPS preparation process, or be based on similar assessments undertaken by other development partners.



56. **Continue harmonizing with other multilateral development banks.** Continued harmonization of approaches to the use of country systems among development partners is required to enhance development impacts, reduce transaction costs, and encourage collaborative behavior to the benefits of partner country clients. Successive global declarations on aid effectiveness have upheld the alignment and harmonization principles stated in the Paris Declaration on Aid Effectiveness (footnote 7). ADB's proposed approach to the use of country systems has kept in view the existing approaches and experiences of other MDBs on the use of country systems in their operations. Box 2 summarizes the existing approaches of the Inter-American Development Bank and the World Bank. ADB's policy and principles, as reflected in its SPS, are also consistent with the current policies of other MDBs.⁵⁰

57. ADB will engage more systematically with other MDBs during the implementation of Phase 1, and review changes being considered by other MDBs in their policies and approaches toward the use of country systems. The World Bank is undertaking a review of its procurement policy, which proposes to allow the use of country procurement systems for ICB based on certain parameters (Box 2). It is also exploring new approaches in its environmental and social

⁵⁰ Footnote 36. See the summary of policies of other multilateral financial institutions in ADB's SPS at Attachment 1.

policy review and update process.⁵¹ The World Bank proposes to shift away from prerequisites of equivalence, acceptability, and gap filling to a focus on project impact and risks. It proposes that an assessment be undertaken to determine what risks would be posed to achieving the project outcomes if the country's environmental and social framework were used. In the event that gaps are identified during the risk assessment, the agreed measures and actions, together with the time frames for completion of such measures and actions, will form part of the environmental and social commitment plan.

**Box 2: Use of Country Procurement and Public Financial Management Systems
by Multilateral Development Banks**

Inter-American Development Bank. The Inter-American Development Bank (IADB) has a systematic approach to the use of country procurement and fiduciary systems, which is guided by its 2010 board-approved policy on the use of country systems. It assesses the equivalence of country systems with IADB required standards for all its client countries, and reports on its progress on the use of country procurement and public financial management systems annually as part of its corporate results framework. The county strategy document includes a section that assesses progress made on the use of country systems. The use of country systems remains partial at best, implying equivalence in some dimensions of country systems. Countries use national competitive bidding (NCB) up to a certain threshold, but all international competitive bidding (ICB) is still done using IADB systems. IADB does not have an exclusive approach for its upper middle-income countries.

World Bank. On fiduciary arrangements and for public financial management, the default is to use country systems. However, the use of country systems is ultimately contingent on the professional judgment of concerned staff based on assessments of minimum competency positions. These positions are informed by Public Expenditure and Financial Accountability results and other analytical country assessments but go beyond them, with World Bank staff using country knowledge to arrive at their professional judgment on the use of country systems. No distinction is made between upper middle-income countries and other client countries on the use of country systems.

Under a new procurement policy of the World Bank expected to be implemented from 1 July 2015, important changes are being contemplated on the use of country procurement systems, under the new banner of "alternative procurement methods." A main change is that in addition to assessments of country-level systems, agency-level assessments will be carried out to determine whether the use of country systems is justified in specific investments. Agencies that are declared competent from the point of view of allowing the use of country systems will be able to use these systems for NCB as well as ICB. For countries that are part of the Government Procurement Agreement under the World Trade Organization, separate country-level procurement assessments will not be required.

Source: Consultations with IADB and World Bank staff.

C. Other Issues

58. **Culture change.** ADB will need a culture change, which will require it to have a bigger risk appetite. Staff will need to balance the requirements of two objectives—the fiduciary requirements of ADB as a provider of funds, with the need to recognize DMCs' interests in improving institutional capacity and performance. Staff can learn from ADB's experience of

⁵¹ World Bank. 2014. Review and update World Bank safeguard policies. World Bank consultation draft. <https://consultations.worldbank.org/consultation/review-and-update-world-bank-safeguard-policies>

processing projects under its RBL modality, where a beginning of this balance between the two objectives has already been made.

59. **Staff skills, incentives, and resources.** Both ADB staff and DMC institutions will need to work on a new framework based on country systems, which will be different from their knowledge and experience of working with ADB's procedures. This change will require staff to adapt and agree to a different way of working, where the main focus is on institutional strengthening and long-term sustainability. ADB staff will need to improve their knowledge of DMCs' national laws. While undertaking robust country systems assessments and more systematic country systems road maps preparation may require greater resources during processing, use of country systems is likely to reduce transaction costs during program implementation for both ADB and DMCs by reducing procedural requirements and avoiding establishment of parallel systems.⁵² While there may be greater short-term costs, professional incentives to staff for the use of country systems in the long term will include timely implementation of projects, leading to higher project success rates and greater satisfaction of client DMCs.

60. Staff awareness and knowledge on the rationale for the use of country systems and for the changed approach will need to be enhanced, starting with the country strategy and project teams covering ADB operations in the six selected DMCs. Disregarding some of these soft elements of a change in approach can lead to a failure in implementation of the use of country systems Phase 1 framework, as the World Bank pilot program experience highlighted (footnote 43). ADB will assess the benefits and costs (including resource implications) of adopting a more systematic approach to the use of country systems at the end of Phase 1 in 2017.

D. ADB's Longer Term Approach: Review and Refine Phase 1

61. **Learn from ADB's and other experiences and refine implementation approach.** In its Phase 2 beginning in 2018, ADB will review and refine its country systems approach based on learning from its experience of Phase 1 implementation, implementation of the principles-based approach in its RBL operations, and in light of other MDBs' policies and approaches toward the use of country systems. ADB will refine its approach from the point of view of ultimately mainstreaming this approach in eligible DMCs, as they progress on improving their institutions and systems.

⁵² A number of benefits and costs are similar to those the staff will experience in processing RBL programs in these DMCs. See ADB. 2013. *Staff Guidance for Piloting Results-Based Lending for Programs*. Manila.

**AVAILABILITY OF PUBLIC FINANCIAL MANAGEMENT ASSESSMENTS IN
ADB'S DEVELOPING MEMBER COUNTRIES**

Group A: ADF financing Group B: OCR and ADF blended financing Group C: OCR financing	GNI Status as of 2013				Public Expenditure and Financial Accountability Assessments			Latest CPARs
	LICs	LMICs	UMICs	HICs	Assessment Year	Public (yes/no)	GNI Status in the PEFA Year	
Afghanistan (A)	X				2013	Yes	LIC	2007
Bhutan (A)		X			2010	Yes	Lower MIC	
Cambodia (A)	X				2011	Yes	LIC	2004
Kiribati (A)		X			2009	No	Lower MIC	
Kyrgyz Republic (A)		X			2009	Yes	LIC	
Lao PDR (A)		X			2010	Yes	Lower MIC	2003
Maldives (A)			X		2009	Yes	Lower MIC	
Marshall Islands (A)			X		2012	No	Upper MIC	
Myanmar (A)	X				2012	Yes	Lower MIC	
Nauru (A)			X		2010	No	Upper MIC	
Nepal (A)	X				2008	Yes	LIC	2002
Samoa (A)		X			2010	Yes	Lower MIC	
Solomon Islands (A)		X			2012	Yes	Lower MIC	
Tajikistan (A)	X				2012	Yes	LIC	2013
Tonga (A)			X		2010	Yes	Lower MIC	2003
Tuvalu (A)			X		2011	No	Upper MIC	
Vanuatu (A)		X			2006	Yes	Lower MIC	
Armenia (B)		X			2014	Yes	Lower MIC	2009
Bangladesh (B)	X				2010	Yes	LIC	2002
Georgia (B)		X			2013	Yes	Lower MIC	2002
India (B)		X			2010	Yes	Lower MIC	2003
Micronesia (B)		X			2013	Yes	Lower MIC	
Mongolia (B)		X						2003
Pakistan (B)		X			2012	Yes	Lower MIC	2009
Palau (B)			X					
Papua New Guinea (B)		X			2009	No	Lower MIC	
Sri Lanka (B)		X			2013	No	Lower MIC	2003
Timor-Leste (B)		X			2010	Yes	Lower MIC	2004
Uzbekistan (B)		X			2012	No	Lower MIC	2003
Viet Nam (B)		X			2013	Yes	Lower MIC	2002
Azerbaijan (C)			X		2008	No	Lower MIC	2009
Cook Islands (C)				X	2011	Yes	Upper MIC	
Fiji (C)			X		2013	No	Upper MIC	
Indonesia (C)		X			2012	Yes	Lower MIC	2001
Kazakhstan (C)			X		2009	No	Upper MIC	2002
Malaysia (C)			X					
PRC (C)			X					
Philippines (C)		X			2010	Yes	Lower MIC	2012
Thailand (C)			X		2009	Yes	Lower MIC	
Turkmenistan (C)			X					
Total	6	20	13	1	35 PEFA assessments carried out	25 Public, 10 Not Public	5 countries have changed GNI status since PEFA assessment was carried out	19 Public 1 Not Public

ADB = Asian Development Bank, ADF = Asian Development Fund, PRC = People's Republic of China, CPAR = country procurement assessment report, GNI = gross national income, HIC = high-income country, Lao PDR = Lao People's Democratic Republic, LIC = low-income country, LMIC = lower middle-income country,

OCR = ordinary capital resources, PEFA = Public Expenditure and Financial Accountability, UMIC = upper middle-income country.

Notes: The GNI status is based on World Bank's 'Analytical Classifications'. The data set does not cover Cook Islands and Nauru, but according to UN Data Cook Islands in 2011 had a GNI per capita of US\$ 13,478 (i.e., HIC status) and Nauru in 2011 a GNI per capita of US\$ 6,746 (i.e., Upper MIC status).

Sources: siteresources.worldbank.org/DATASTATISTICS/Resources/OGHIST.xls; <http://data.un.org/Default.aspx>; PEFA Secretariat. 2014. PEFA performance indicator scores of Completed and Final Draft National Level PEFA Based Assessment Reports [PEFA Scores-Jun.14-Final-Public]. Unpublished; <http://documents.worldbank.org/curated/en/home>.

STRENGTH OF PUBLIC FINANCIAL MANAGEMENT AND PROCUREMENT SYSTEMS OF SELECTED UPPER MIDDLE-INCOME COUNTRIES OF ADB

1. This appendix provides an analysis of the status of public financial management (PFM)¹ and procurement systems of the six upper middle-income countries (UMICs) considered in this paper (Azerbaijan, the People’s Republic of China (PRC), Kazakhstan, Malaysia, Thailand, and Turkmenistan). Standard assessments and documentation on the six UMICs is limited. Only one developing member country (DMC), Thailand, had a publicly available Public Expenditure and Financial Accountability (PEFA) assessment; and only one DMC, Kazakhstan, had a publicly available country procurement assessment report (CPAR). The analysis here makes use of other available documentation, including Asian Development Bank (ADB) risk assessments and risk management plans (RAMPs).

2. **Azerbaijan.** Available assessments suggest moderate to substantial risk in PFM and high risk status in procurement systems. ADB cannot, therefore, consider the use of country PFM systems or country procurement systems in the short term.

3. While a PEFA assessment was carried out for Azerbaijan in 2008 and a CPAR in 2009, neither of the reports are public. Various assessments suggest that Azerbaijan has a relatively well-functioning PFM system in some areas, but a number of weaknesses in other key PFM performance areas. The areas where performance is better include a high level of budget credibility as well as generally comprehensive and transparent budget processes. However, shortcomings exist in other areas, including policy-based budgeting, predictability and control in budget execution and accounting and reporting, and external scrutiny and audit. According to PEFA analysis, the strongest dimension of Azerbaijan’s PFM system in 2008 was credibility of the budget, while the weakest was external scrutiny and audit.²

4. The strategy documents prepared by ADB for Azerbaijan—the country partnership strategy, 2014–2018, and the country operations business plan, 2014–2016—do not include discussions on PFM or procurement systems’ assessments or of the use of country systems.³ There is also no analysis on the extent of use of these systems in ADB’s operations.

5. ADB’s 2014 governance RAMP for Azerbaijan provides an overview of governance issues as well as detailed summaries regarding the functioning of PFM (at the national level as well as in priority sectors), procurement, and anticorruption systems.⁴ It also outlines ongoing reforms and includes a risk matrix and risk management plan. The RAMP recognizes efforts of the World Bank on joint work with national institutions, but no overview is provided on ADB’s efforts or ADB’s current use of country systems. Its PFM risk matrix lists a number of areas and aspects as high risk.⁵

¹ The PEFA Secretariat proposes to review the PEFA framework, and include three new areas—fiscal strategy, public asset management, and public investment management. PEFA Secretariat. 2014. Updating the PEFA Performance Measurement Framework. Washington, DC. pp. 4–5.

² ADB. 2014. Financial Management-Related References. Financial Management Training Program, Tashkent, 10–14 March. pp. 40–41.

³ ADB. 2014. *Country Partnership Strategy: Azerbaijan, 2014–2018*. Manila; ADB. 2013. *Country Operations Business Plan: Azerbaijan, 2014–2016*. Manila.

⁴ ADB. 2014. *Risk Assessment Report and Risk Management Plan: Azerbaijan*. Manila.

⁵ Footnote 4. The RAMP notes that the World Bank is planning to conduct joint audits and post-procurement reviews together with the Chamber of Accounts, which “will be an important step in the use of country systems” (p. 13). Also, it mentions that “at present, Azerbaijan’s country system for procurement is inadequate to ensure the transparency and competitiveness required by ADB” (p. 25).

6. Further, an independent evaluation report confirms weaknesses in accounting, reporting, and auditing standards.⁶ The report states that although Azerbaijan's Accounting Law, 2004 provided for financial reporting in accordance with national standards consistent with the International Public Sector Accounting Standards (IPSAS), by 2009 this had not happened across the government's PFM system. Regarding external audit, it noted that not all financial statements are audited on an annual basis by the Chamber of Accounts, and that the Chamber of Accounts lacks constitutionally provided independence and the right and the responsibility to report to Parliament in accordance with internationally accepted standards. Both ADB and the World Bank require that project accounts be audited by independent external auditors in accordance with the International Standards on Auditing. ADB's 2014 RAMP, however, notes a number of steps that are being taken to address the weakness in the PFM systems. For example, the European Union is supporting a PFM action plan, and the government is likely to develop a strategy to implement international standards in internal audits (footnote 4).

7. On procurement, although the CPAR on Azerbaijan was not made public, a 2011 report by the World Bank's Independent Evaluation Group quoted and concurred with the 2008 CPAR finding that "public procurement left too much discretion and had insufficient controls to prevent fraud and corruption."⁷ The World Bank report further mentioned that strengthening procurement is relevant, but there is widespread concern that the new procurement law may not be properly implemented. Azerbaijan's procurement system has a relatively high PEFA procurement indicator (PI-19) score (3 or moderate risk).⁸ ADB's preliminary assessment rates it high risk.⁹ ADB's 2014 RAMP noted "numerous shortcomings inherent in the law and associated procurement processes."¹⁰

8. **People's Republic of China.** No PEFA assessment or CPAR has been carried out for the PRC. However, based on ADB's sustained operations and knowledge in some sectors over many years, it is potentially possible to use country- or sector-specific PFM and procurement systems. ADB's shift in loan portfolio toward lagging and remote regions will require a sector and agency level specific diagnostics, since these regions may have comparatively weak systems and implementing agencies may lack capacity and experience.

9. As part of its long-term partnership with the PRC, ADB has provided support for strengthening government systems and the fiduciary framework. For example, ADB's CPS, 2011–2015 for the PRC mentioned that, for good governance and capacity development, ADB would support the government's efforts to strengthen fiduciary frameworks and practices to (i) improve the delivery and management of infrastructure and public services, and (ii) promote the enabling environment for private sector development.¹¹ The PRC's 2006 update of the

⁶ ADB. Undated. Financial Management Arrangements – Azerbaijan. [14-02-18 140214 CWRD-DMC Template – AZE].

⁷ Independent Evaluation Group (IEG). 2011. Azerbaijan: World Bank Country-Level Engagement on Governance and Anticorruption. *IEG Working Paper Series*. No. 2011/9. Washington, DC: World Bank.

⁸ PI-19 by itself, given its limited scope, cannot be used to assess the procurement system as a whole.

⁹ ADB. 2014. *Procurement Reform – 10 Point Action Plan: New Staff Instruction and Revised Project Administration Instructions 3.01–3.12*. Manila (memorandum issued by Operations Services and Financial Management Department on 22 July).

¹⁰ Footnote 4. P.23.

¹¹ ADB. 2012. *Country Partnership Strategy: People's Republic of China, 2011–2015*. Manila.

Accounting Law brought its accounting and financial reporting standards into substantial compliance with the International Financial Reporting Standards on audit.¹²

10. In the case of procurement, available assessments point out that the PRC's Procurement Law and the Law on Tendering and Bidding are sound, and establish a broader legal framework for public procurement. ADB's country partnership strategy linked documents outlined some institutional and legislative frameworks, but did not provide assessments of the functioning of the procurement system. It was noted that differences remained between the PRC procurement systems and ADB procedures, but that compliance with ADB's procurement and disbursement procedures generally was satisfactory. Further, in sectors where ADB has provided continued support (e.g., wastewater management and railways), the quality of procurement seemed to be reasonable.¹³

11. Under ADB's recent procurement reform measures, with the PRC's preliminary rating of medium risk, its prior review contract (works/plant/goods) threshold is higher (at \$10 million), i.e., contract value below this amount will be subject to post review.¹⁴ This will imply greater reliance on national competitive bidding procedures (country procurement systems).

12. **Kazakhstan.** A PEFA assessment report was carried out for Kazakhstan in 2009, but its details were not made public. A CPAR was carried out in 2002 for Kazakhstan, which is considered dated. No recent report is available. Based on other available assessments, Kazakhstan is considered to be moderate risk in PFM and medium risk in procurement systems. ADB, therefore, can potentially systematically consider a move toward the use of country PFM and procurement systems. However, given a lack of robust assessments, ADB should consider a systematic move to consider the use of country systems only after more systematic diagnostics are undertaken.

13. Kazakhstan has a well-functioning PFM system, in particular regarding budget credibility, accounting and recording, budget execution, and policy-based budgeting. The only major shortcoming appeared to be the quality and timeliness of annual financial statements. However, the government since January 2013 prepares and presents public sector financial statements that comply with IPSAS standards.¹⁵ There is also movement toward compliance with international accounting and reporting standards. The government, since January 2013, prepares and presents public sector financial statements that comply in all material respects with accrual-basis IPSAS (footnote 2).

14. ADB's country partnership strategy (CPS), 2012–2016 for Kazakhstan mentioned that in the area of governance and institutional reforms, ADB would support “project management and portfolio performance through improved financial management, audits, and procurement.”¹⁶ The

¹² Risk Assessment and Risk Management Plan (Summary). Accessible from the list of linked documents in ADB. 2012. *Country Partnership Strategy: People's Republic of China, 2011–2015*. Manila (Appendix 2). Footnote 31, Linked Document 10 'Risk Assessment and Risk Management Plan (Summary).

¹³ ADB. 2007. *People's Republic of China: Procurement, Financial Management, and Anti-Corruption in ADB Financed Projects*. Consultant's report. Manila.

¹⁴ ADB. 2014. *Procurement Reform – 10 Point Action Plan: New Staff Instruction and Revised Project Administration Instructions 3.01–3.12*. Manila (memorandum issued by Operations Services and Financial Management Department on 22 July).

¹⁵ ADB. (undated). *Financial Management Arrangements – Kazakhstan*. [14-02-18 140214 CWRD-DMC Template - KAZ].

¹⁶ ADB. 2012. *Country Partnership Strategy: Kazakhstan, 2012–2016*. Manila (p. 7).

CPS did not mention the use of country systems in relation to PFM and procurement.¹⁷ ADB's 2011 RAMP for Kazakhstan provided an overview regarding PFM and procurement at the national level and major sectors as well as brief discussions of key issues and risks. Its PFM risk matrix listed the following major risks for PFM: (i) the bottom-up approach used in the compilation of estimates; (ii) increase of the actual cost of projects versus the budgeted expenses; (iii) weakness of the audit function in terms of the experience and methodology applied; and (iv) weak monitoring at operational level. Similarly, the 2012 risk assessment and risk management plan (summary) noted some risks for ADB operations, including the auditing processes of the government.¹⁸

15. Recent ADB reviews (2011 RAMP and CPS, 2012–2016) indicate that Kazakhstan's procurement system has a number of weaknesses. These include weak competition in the tendering process, lack of transparency to control rent-seeking, and corruption.¹⁹ The PEFA PI-19 score for Kazakhstan was 3 (B), which indicates moderate risk. The procurement risk matrix in ADB's 2011 RAMP included five major risks, but these did not relate to procurement frameworks, capacities, or procedures.²⁰ The risk assessment and risk management plan (summary) listed the procurement system risks associated with ADB operations as: (i) weak competition in the tendering process; and (ii) the need for greater transparency to control rent-seeking and corruption.

16. **Malaysia.** No PEFA assessment or CPAR have been carried out for Malaysia. Quick diagnostics could be undertaken if ADB restarts sovereign operations in Malaysia. However, based on available indicators, Malaysia is likely to have a moderate PFM rating. ADB's preliminary procurement risk rating for Malaysia is medium risk.

17. ADB prepared an interim CPS, 2011–2012 for Malaysia in 2011.²¹ Neither the interim CPS nor the risk assessment and risk management plan discuss PFM, procurement, or fiduciary risks. There is no discussion on use of country systems. If ADB restarts sovereign investment lending operations in Malaysia, an assessment by ADB can be undertaken to assess the fiduciary PFM and procurement risk at the national and agency level. Given that Malaysia is likely to have moderate PFM and medium procurement risk rating, ADB could consider the use of country systems. ADB could also get comfort from the fact that Malaysia ranks high on most of the Worldwide Governance Indicators, e.g., voice and accountability, government effectiveness, regulatory quality, rule of law, and control of corruption. On two indicators—government effectiveness and regulatory authority—only Malaysia ranks above the 70th percentile among the UMICs group, while the other UMICs do not rank above the 61st percentile for either indicator.²²

¹⁷ The CPS did state that the results framework was closely aligned with the government's strategic plan and industrialization program, and that results would be monitored using country systems during country portfolio review missions (p. 10).

¹⁸ Risk Assessment and Risk Management Plan (Summary). Accessible from the list of linked documents in ADB. 2012. *Country Partnership Strategy: Kazakhstan, 2012–2016*. Manila (Appendix 2).

¹⁹ ADB. 2012. *Country Partnership Strategy: Kazakhstan, 2012–2016*. Manila; and Appendix 2 linked document.

²⁰ The five major risks identified were (i) inadequate transparency and accountability of state bodies; (ii) inadequacy of the remuneration system of civil servants; (iii) absence of competition in some tenders resulting from the formulation of the request; (iv) no English version available in the e-procurement, with a limitation for foreign companies to participate to different tenders; and (v) weak application of the conflict of interest regulation.

²¹ ADB. 2011. *Interim Country Partnership Strategy: Malaysia, 2011–2012*. Manila.

²² ADB. 2015. *Clients–Contributors–Collaborators: A New Partnership with Upper Middle-Income Countries*. Manila.

18. **Thailand.** A PEFA assessment undertaken for Thailand in 2009 is available, but no CPAR is available. Based on all available assessments, Thailand's PFM systems are considered moderate risk and its procurement systems medium risk. ADB can consider a move toward the use of country PFM systems, with mitigation measures to address risks related to the transparency of intergovernmental fiscal relations and the legislative scrutiny of external audit reports. On procurement, more systematic diagnostics is required.

19. Thailand has a well-functioning PFM system, especially with respect to budget credibility, budget execution, and comprehensive and transparent procedures, according to the PEFA assessment. The overall average indicates a risk rating of moderate for the PFM system. Shortcomings were assessed in two areas—transparency of intergovernmental fiscal relations (PI-8) and legislative scrutiny of external audit reports (PI-28).²³ Dimension-level PEFA scores are presented in Table A2.

Table A2: Dimension-Level Public Expenditure and Financial Accountability Scores – Thailand, 2009

PEFA Dimension	Average Score
A. Credibility of the budget	3.75
B. Comprehensiveness and transparency	3.00
C. Policy-based budgeting	3.00
D. Predictability and control in budget execution	3.28
E. Accounting, recording, and reporting	2.88
F. External scrutiny and audit	2.50
Overall Average	3.13

PEFA = Public Expenditure and Financial Accountability.

Source: World Bank. 2009. *Kingdom of Thailand- Public Expenditure and Financial Accountability: Public Financial Management Assessment*. <https://openknowledge.worldbank.org/handle/10986/3193?show=full>

20. ADB's 2012 RAMP for Thailand, which provided an overview of recent PFM and procurement diagnostics at the national level, was based almost exclusively on the 2009 PEFA assessment.²⁴ The risk matrix in the RAMP did not list any major risks for PFM. The RAMP also did not discuss the issue of the use of country systems. The risk assessment and risk management plan (summary), however, noted some risks—including weaknesses in evaluating discrepancies between budget provisions and actual expenditure, and lack of transparency in the functional or economic allocation of expenditure by local authorities. ADB's CPS, 2013–2016 for Thailand mentioned that ADB operations and activities in Thailand would mainstream three crosscutting priorities, including good governance, by supporting effective planning, procurement, financial management, and anticorruption measures.²⁵ The CPS did not mention the use of country systems in relation to PFM and procurement.²⁶

21. Available documentation on procurement is limited, as mentioned earlier. No CPAR has been carried out for Thailand. The PEFA PI-19 score for Thailand was 3 (B), which indicates

²³ World Bank. 2009. *Kingdom of Thailand Public Expenditure and Financial Accountability: Public Financial Management Assessment*. Report No. 56094. p. i, ii and iii.

²⁴ ADB. 2012. *Country Governance Risk Assessment and Risk Management Plan: Thailand*. Manila (Project Number: TA-7277). Unpublished.

²⁵ ADB. 2013. *Country Partnership Strategy: Thailand, 2013–2016*. Manila.

²⁶ The CPS did state that country systems would be used to track progress in achieving CPS outcomes.

moderate risk. ADB's CPS, 2013–2016 mentioned that more effective and efficient use of public resources would follow from improvements in public procurement.²⁷ Furthermore, the risk assessment and risk management plan (summary) noted that procurement systems were weak, with a fragmented regulatory framework and at times ineffective oversight and enforcement mechanisms. It also found a lack of central oversight to ensure that the government, state-owned enterprises, and local governments observed relevant procurement regulations.

22. The procurement section in ADB's 2012 RAMP is based on the PEFA PI-19 as well as some procurement studies undertaken during 2005–2009. The procurement risk matrix in the RAMP included major risks, such as unfair practices in tendering and bidding processes. A more robust procurement diagnostics will be required before ADB considers the use of country procurement systems in ADB's sovereign investment lending operations in Thailand.

23. **Turkmenistan.** No PEFA assessment or CPAR has been undertaken for Turkmenistan. ADB is preparing a CPS for Turkmenistan. The country operations business plan, 2014–2015 does not include information about PFM, procurement, or fiduciary risks; and the use of country systems is not mentioned.²⁸ A note on PFM and governance prepared for the interim CPS, 2014–2015 mentions that several new laws have been made and significant reforms are in progress. A shift toward the International Financial Reporting Standards (based on a new Law on Financial Accounting and Reporting) is being undertaken, and a greater level of decentralization in the budget system is planned.²⁹ The note also mentions that Turkmenistan's Stabilization Fund and the Foreign Exchange Reserve Fund require further measures to enhance transparency in their functioning (i.e., a significant amount of revenue and expenditure remains outside the main state budget). Key governance issues related to PFM that were noted concern the lack of information disclosure and the government's propensity for large-scale investment projects.

²⁷ ADB. 2013. *Country Operations Business Plan: Turkmenistan, 2014–2015*. Manila (p. 4).

²⁸ ADB. 2013. *Country Operations Business Plan: Turkmenistan, 2014–2015*. Manila.

²⁹ ADB. Undated. Public Financial Management and Governance Assessment, *Interim Country Partnership Strategy: Turkmenistan, 2014–2015*.

APPROACH FOR MEASURING FIDUCIARY RISKS USING PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY PERFORMANCE INDICATORS

1. The World Bank, at the Fiduciary Forum in March 2008, presented an approach to use a selection of 19 Public Expenditure and Financial Accountability (PEFA) performance indicators (PIs) out of the total 28 PIs to assess the fiduciary risks in the use of country PFM systems for World Bank-supported projects.¹

2. For the purposes of this paper, two minor adjustments have been made to the World Bank's approach: PI-27 (legislative scrutiny of the annual budget law) and PI-28 (legislative scrutiny of external audit reports), which in the World Bank's approach had been included under the internal controls and internal audit category, have been placed under the budgeting and external audit categories, as the Asian Development Bank (ADB) considers this a more appropriate categorization.

Table A3: Adjusted World Bank Approach for Assessing Fiduciary Risks Using Public Expenditure and Financial Accountability Assessment Performance Indicators

Components/PI	Description
A	Budgeting
PI-1	Aggregate expenditure outturn compared with original approved budget
PI-2	Composition of expenditure outturn compared with original approved budget
PI-4	Stock and monitoring of expenditure payment arrears
PI-5	Classification of the budget
PI-10	Public access to key fiscal information
PI-27	Legislative scrutiny of the annual budget law
B	Accounting and Financial Reporting
PI-7	Extent of unreported government operations
PI-23	Availability of information on resources received by service delivery units
PI-24	Quality and timeliness of in-year budget reports
PI-25	Quality and timeliness of annual financial statements
C	Treasury Management and Funds Flows
PI-16	Predictability in the availability of funds for commitment of expenditures
PI-17	Recording and management of cash balances, debts, and liabilities
D	Internal Controls and Internal Audit
PI-18	Effectiveness of payroll controls
PI-19	Competition, value for money, and controls in procurement
PI-20	Effectiveness of internal controls for non-salary expenditure
PI-21	Effectiveness of internal audit
PI-22	Timeliness and regularity of accounts reconciliation
E	External Audit
PI-26	Scope, nature, and follow-up of external audit
PI-28	Legislative scrutiny of external audit reports

PI = performance indicator.

¹ World Bank. 2008. Assessment of Fiduciary Risks in the Use of Country PFM Systems for Bank-Supported Projects. Presentation at the March Fiduciary Forum.

PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY SCORES AND FIDUCIARY RISK RATINGS

1. Public Expenditure and Financial Accountability (PEFA) scores have been translated into fiduciary risk ratings for public financial management (PFM) and procurement systems using the Asian Development Bank (ADB) terminology of risk ratings (low, moderate, substantial, high) as shown in Table A4. Mitigation measures have not been taken into account in the descriptions provided.

Table A4: Explanation of Fiduciary Risk Ratings

PEFA Score	Risk Level	Risk Description
4 (A)	Low	The structure of the PFM and procurement systems broadly reflects good international practice, and there is routine compliance with the majority of controls within the systems.
3 (B)	Moderate	The structure of the PFM and procurement systems broadly reflects good international practice, although some gaps or inefficiencies may exist. There is basic compliance with controls within the systems but regular exceptions occur.
2 (C)	Substantial	The structure of the PFM and procurement systems falls short of good international practice in a number of areas and/or there are numerous and/or material weaknesses in compliance with many of the controls within the systems.
1 (D)	High	The structure of the PFM and procurement systems shows significant divergence from good international practice and/or there is widespread lack of compliance with many of the controls within the systems.

PEFA = Public Expenditure and Financial Accountability, PFM = public financial management.

Note: The PEFA framework is based on qualitative ratings of A, B+, B, C+, C, D+ and D. To make quantitative calculations of PEFA scores, the following conversions are made:

Low risk: A = 4, low to moderate risk: B+ = 3.5, moderate risk: B = 3, moderate to substantial risk: C+ = 2.5, substantial risk: C = 2, substantial to high risk: D+ = 1.5, high risk: D = 1.

The use of PEFA scores to compare the performance of country PFM systems or by converting them to numerical scores should be treated with caution. PEFA was designed to compare a country's performance over time. However, in this paper, a comparison across countries has been made to draw broad conclusions on the strength of country PFM systems for selecting developing member countries (DMCs), rather than make specific decisions on the use of country systems in these DMCs. The paper suggests the need for robust diagnostics and analysis for taking decisions on the use of country systems.

Source: ADB Staff calculations based on World Bank. 2008. Assessment of Fiduciary Risks in the Use of Country PFM Systems for Bank-Supported Projects, presentation at the March Fiduciary Forum. Average PEFA scores were calculated for different country groups and countries using Adjusted World Bank Approach for Assessing Fiduciary Risks.

DEFINITIONS OF THE USE OF COUNTRY PUBLIC FINANCIAL MANAGEMENT AND PROCUREMENT SYSTEMS

A. Development Assistance Committee of the Organisation for Economic Co-operation and Development Guidance on Monitoring the Paris Declaration

1. Using country public financial management (PFM) and procurement systems was defined as follows in the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD-DAC) guidance for the 2011 survey on monitoring the Paris Declaration, which measured the status for 2010:¹

2. Public financial management. An average of the three scores is taken to calculate the use of country PFM systems for any country: (i) national budget execution procedures, (ii) national financial reporting procedures, and (iii) national auditing procedures:

(i) Use of national budget execution procedures required that three of the following four criteria were met (Answers – Yes or No):

- a. Are your funds included in the annual budget approved by country legislature?
- b. Are your funds subject to established country budget execution procedures?
- c. Are your funds processed (e.g., deposited and disbursed) through the established country treasury system?
- d. You do NOT require the opening of separate bank accounts for your funds?

(ii) Use of national financial reporting procedures required that both the following criteria were met (Answers – Yes or No):

- a. You do NOT require maintenance of a separate accounting system to satisfy your own reporting requirements?
- b. You ONLY require financial reports prepared using country's established financial reporting arrangements?

(iii) Use of national auditing procedures required that both the following criteria were met (Answers – Yes or No):

- a. Are your funds subject to audit carried out under the responsibility of the Supreme Audit Institution (SAI)?
- b. You do NOT under normal circumstances request additional audit arrangements?

And at least one of the following two criteria:

- c. You do NOT require audit standards different from those adopted by the SAI?
- d. You do NOT require the SAI to change its audit cycle to audit your funds?

3. Procurement: Use of national procurement systems: Donors use national procurement systems when funding for project and program implementation is managed according to the national procurement procedures as they were established in the general legislation and

¹ OECD. 2010. 2011 Survey on Monitoring the Paris Declaration – Survey Guidance, Version: 28 September. pp. 21–26.

implemented by government. The use of national procurement procedures means that donors do not make additional, or special, requirements for procurement of works, goods, and services.

B. 2013 Global Partnership Monitoring Survey: Modification on Use of Country Systems Indicator

4. Under the 2013 global monitoring survey, the two indicators on use of country systems (i.e., PFM and procurement) were combined to offer a single composite indicator—use of country PFM and procurement systems. As a result, procurement is now one of the four components of country systems (i.e., budget execution, financial reporting, auditing, and procurement) rather than being subject to a separate target. There is no change in the guide questionnaire for various subcomponents.