EC Budget Support: thumbs up or down?

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Abbreviations

ACP	African, Caribbean and Pacific
BCC	Budget Control Committee
CPA	ACP-EU Cotonou Partnership Agreement
CSE	Country Strategy Evaluation
CSP	Country Strategy Paper
EC	European Commission
EDF	European Development Fund
EU	European Union
IFI	International Financial Institution
IMF	International Monetary Fund
HIPC	Heavily Indebted Poor Country
MDGs	Millennium Development Goals
NAO	National Authorising Officer
OECD/DAC	Organisation for Economic Cooperation and Development/ Development Assistance Committee
PAF	Poverty Alleviation Fund
PFM	Public Finance Management
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
RAO	Regional Authorising Officer
SPA	Strategic Partnership with Africa

Preface

Budget support is a form of macro-economic financial assistance that is designed to prioritise the fight against poverty and the achievement of the Millennium Development Goals (MDGs). The European Commission (EC) is providing more and more budget support under the Cotonou Partnership Agreement (CPA), which structures the provision of assistance by the European Union (EU) to the African, Caribbean and Pacific (ACP) countries. The EC also provides macro-economic support through its cooperation agreements with a number of non-ACP countries, for which it is now also introducing budget support.

During the course of its work in the ACP regions, the European Centre for Development Policy Management (ECDPM) was approached by parliamentarians, representatives of non-governmental organisations and partner government officials, all of whom had certain questions to ask about the background to and operation of budget support. These actors regard budget support as an increasingly important mechanism for development cooperation, and one that has potentially far-reaching implications for their work. At the same time, it is a relatively new mechanism, is poorly understood and is driven by a relatively small group of experts in aid agencies and partner country finance or planning ministries.

We have prepared this Discussion Paper in response to these queries. Our aim is to give policy-makers and practitioners in-depth information on the nature and potential of, and the constraints associated with, budget support as a development cooperation modality. The paper explains the complex nature of budget support and its implications for the actors involved, as well as highlighting issues that have a bearing on its success.

Budget support creates opportunities that are not always fully appreciated by its critics. At the same time, it creates risks which tend to be downplayed by its supporters. Against this background, this paper also aims to contribute to this intensely debated issue by providing a balanced view for those seeking to understand its complexities.

As this is intended to be a relatively brief paper, it is limited to key policy issues and the challenges arising from recent experiences with budget support. For this reason, we have not devoted much space to discussing the issue of **sector budget support**. We advise the reader to consult the bibliography for more detailed information on the practice and technicalities of this rapidly evolving mechanism.

Finally, it is important to recognise that the move towards budget support has aroused many questions among partner government officials, donor agencies, consultants and academic institutes, which tend to feed into the production of specialist documents assessing approaches and experiences. For this reason, this paper can do no more than to describe the current state of a rapidly evolving debate and practice. We hope to be able to follow up this initial study and produce further publications on specific issues, tailored to the needs of individual ACP audiences, as part of our future work.

1 Introduction

Budget support was introduced to international development cooperation in the late 1990s. Its appearance was part of a general reorientation of aid, at a time when greater emphasis was placed on poverty reduction. The key elements of this changing policy agenda, which has now been espoused by much of the donor community, including the EC, are:

(i) improved partnerships and increased ownership through the delegation of more rights and obligations to recipient countries;
(ii) the alignment of donor strategies and activities with the partner country's development framework; and
(iii) enhanced harmonisation of approaches and procedures within the donor community and with the partner countries.

Budget support was seen as a means of putting this agenda into effect as it replaces costly, project-based and highly fragmented aid practices with more efficient and rapidly disbursable resource flows. The idea was that partner countries should assume ownership of resources, engage in meaningful public sector and finance reforms, improve governance by creating better accountability mechanisms, and hence help to reduce poverty in the longer term.

The principles of the new policy agenda and the use of budget support are written into the Cotonou Partnership Agreement between the EU and the ACP countries (CPA). The European Commission (EC) sees budget support and the innovations which come with it as a promising means of phasing out old-style structural adjustment programmes based on conditionalities. Where possible, the EC seeks to link the provision of budget support to the implementation of a country-owned Poverty Reduction Strategy (PRS). This implies a close dialogue with governments and other donors to ensure that the EC's strategy and the quality of its interaction are in line with the priorities set by the partner country.

The EC has invested heavily in budget support (in terms of conceptual understanding and training) in recent years, and has marked it - where possible - as a model for the future delivery of development cooperation (EC 2003 [a]: 9). In parallel with the World Bank and DfID (UK), the EC has also made rapid progress in terms of disbursements.

The issue of budget support has been controversial within Europe, however. While many EU member states agree with it in principle, there has been a fierce dispute about its practical feasibility, with a number of member states expressing concern that it is being put into practice too rapidly. Other member states disagree fundamentally with the principle of budget support, on the grounds that it runs counter to their practice of project support, direct control and the visibility of assistance. The debate has been intense within the European Parliament, which has very little control over the funds disbursed under the CPA. Budget support for the ACP countries originates from the intergovernmental European Development Fund (EDF), which is financed by the member states.

Contents of the paper
This paper starts out by briefly outlining the role played by budget support in the context of macroeconomic stabilisation and poverty reduction, with special emphasis on the provision of budget support under the CPA. The third section of the paper discusses the EC's policy on budget support. This discussion is complemented with figures on the budget support that has been programmed under the CPA to date. Section four presents different views on EC budget support, notably those of representatives of European institutions and partner countries, speaking from their experiences . The final section summarises the pros and cons of this new aid mechanism and discusses the extent to which EC budget support can potentially contribute to intermediate outcomes, such as country ownership and capacity development, and to poverty reduction in the long term.

2. Budget support in the context of the CPA

2.1. A brief excursion into macro-economics

Economically speaking, budget support is a mechanism for supporting the balance of payments of a national economy. There is nothing new about balance-of-payments support, however. After gaining their independence, most ACP countries received loans and grants from their former colonial governments and the international financial institutions (IFIs), the IMF and the World Bank, to promote (investments through) imports. Under the leadership of the IFIs, balance-of-payments support was continued under the structural adjustment facilities created in the 1980s. Several bilateral donors followed the lead set by the IFIs and contributed to these facilities. The transfer of funds was made conditional, however, on the adoption of drastic economic and institutional reforms. Structural adjustment often lacked any form of accountability, monitoring was relatively weak and recipient governments' commitment to policy reform was low.

As structural adjustment did not have the desired impact on national development and poverty reduction, the donor community shifted its focus in the 1990s from financing and economic stabilisation alone to poverty-oriented macro-economic support. The EC followed this trend as of 1995, when it made budget support, a specific form of programme aid (see box 1), available to certain countries.[1]

Macro-economic support further evolved under the CPA (2000-2005), which regulates the employment of mechanisms for providing macro-economic financial assistance to the ACP economies.[2]

- One mechanism is the provision of balance-of-payments support to allow for:
  - external debt servicing through the Heavily Indebted Poor Countries (HIPC) initiative. The rationale here is that the relief of debt burdens will free up national resources for investments in social development and economic growth. A Poverty Reduction Strategy Paper (PRSP) is required for accessing the scheme.
  - external trade payments, through General Import Programmes (the rationale being that countries need to have import capacities to maintain economic growth); and
  - the balancing of short-term fluctuations in export earnings from commodities to safeguard macro-economic and sectoral reforms and policies.[3]
- Another mechanism is '(direct) budget support', which should preferably be linked to the implementation of a Poverty Reduction Strategy (PRS) for the country in question. It provides resources either as a contribution to a country's national budget through (non-earmarked) General Budget Support, more recently also referred to as Poverty Reduction Budget Support, or as Sector Budget Support. The latter is ideally based on a sector-wide approach (SWAp), through which donor agencies pool funding for a particular sector or cross-cutting issue, such as support for decentralisation ('sector earmarking').[4] Budget support from the EC can also be 'earmarked' for the funding of specific types of expenditure.

While a large proportion of balance-of-payments support consists of the provision of convertible currencies to augment imports or for debt servicing purposes, budget support aims to finance state expenditure in priority development sectors. The qualitative monitoring of this financing process and its outcomes is a key ingredient in this approach.

Notes

1 Until the 7th EDF (1990-1995), support for structural adjustment was provided primarily through *General Import Programmes*, but was revised with the signing of Lomé IV bis in 1995. Countries with convertible and freely transferable currencies were then entitled to *Direct Budget Support*, a change which was supported by the European Court of Auditors in its 2001 report on the use of counterpart funds.

2 In addition to financial aid, food is also provided as programme aid. The latter is a form of *indirect budget support* and is provided either in kind or in the form of a currency facility. It requires the justification of the use of foreign exchange through import documents and a counter-value fund in local currency.

3 This system of commodity support was set up under the ACP-EU Lomé Conventions to mitigate the harmful consequences to ACP producers of unstable agricultural export earnings (STABEX) and income from the mining sector (SYSMIN). Although the two systems were discontinued when the CPA was agreed, the Convention still provides financial envelopes to remedy the adverse effects of unstable export earnings (in EC terminology, these envelopes are now known as FLEX).

4 With regard to sector budget support, the donor community uses different forms of 'earmarking'. Some donors leave the use of sector funds to the discretion of the sector ministry, based on a sector strategy setting out broad objectives. Others earmark sector funds for specific programmes or projects within a sector and keep a close eye on spending.

The shift in the nature of macro-economic support from up-front conditionalities under structural adjustment to the provision of negotiated budget support accompanied a general tendency throughout the second half of the 1990s for the development community to refocus its efforts on poverty reduction. This shift in focus was also reflected by the contents of the CPA, which contained three fundamental innovations in this regard, namely:

(i) setting poverty reduction as a core objective;
(ii) underlining the need for ACP states to decide on their development strategies; and
(i) making the partnership all-inclusive by extending it to non-state actors.

2.2. What does Cotonou say?

The legal basis for budget support is laid down in a number of articles regulating development finance cooperation between the EU and its ACP partners.[5] In the light of the current European debate on the suitability of budget support, it is worth taking a closer look at the eligibility articles regulating the nature and methods of financing.

Under Article 61 of the CPA, direct budgetary assistance in support of macro-economic or sectoral reforms may be granted if:

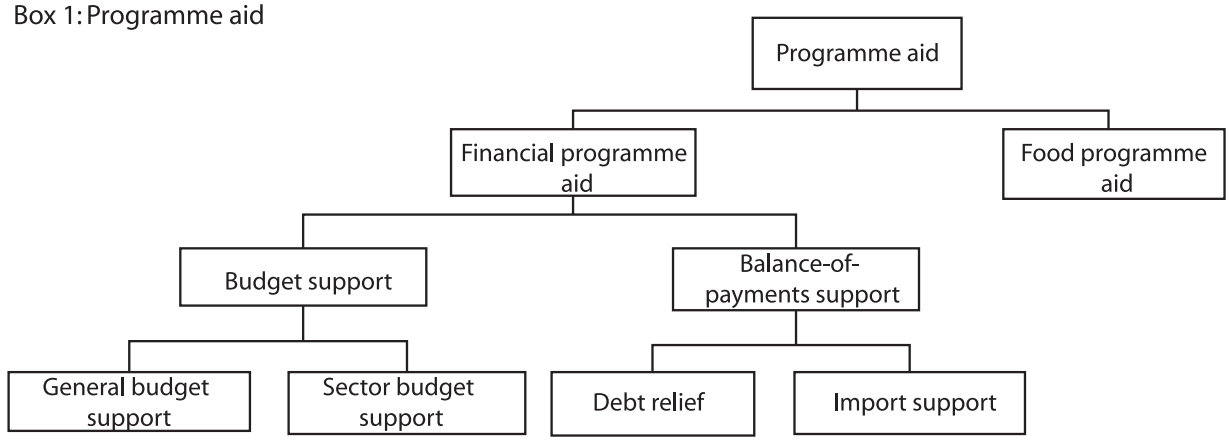
- *public expenditure management is sufficiently transparent, accountable and effective*;
- *well defined macro-economic or sectoral policies established by the country itself and agreed to by its main donors are in place; and*
- *public procurement is open and transparent*.

Evidently, these conditions are hard to find in most ACP countries and, if taken as absolute criteria, would result in very few countries actually being eligible for budget support. However, the CPA recognises the importance of a process-oriented approach to development.[6] This is also reflected by the terms of Article 67, on Structural Adjustment Support:

- *Par 4: ACP states which undertake reform programmes that are acknowledged and supported at least by the principal multilateral donors, or that are agreed with such donors but not necessarily financially supported by them, shall be treated as having automatically satisfied the requirements for adjustment assistance*.
- *Par 5: Structural adjustment support shall be mobilised in a flexible manner and in the form of sectoral and general import programmes or budgetary support*.

Whilst the CPA does provide a legal basis for moving ahead on budget support, the terminology used in Article 61 (*sufficiently transparent* and *well defined...policies*) does leave substantial room for interpretation.

Box 1: Programme aid



Source: ToR for the Joint Evaluation of General Budget Support, DAC 20 April 2004

Notes

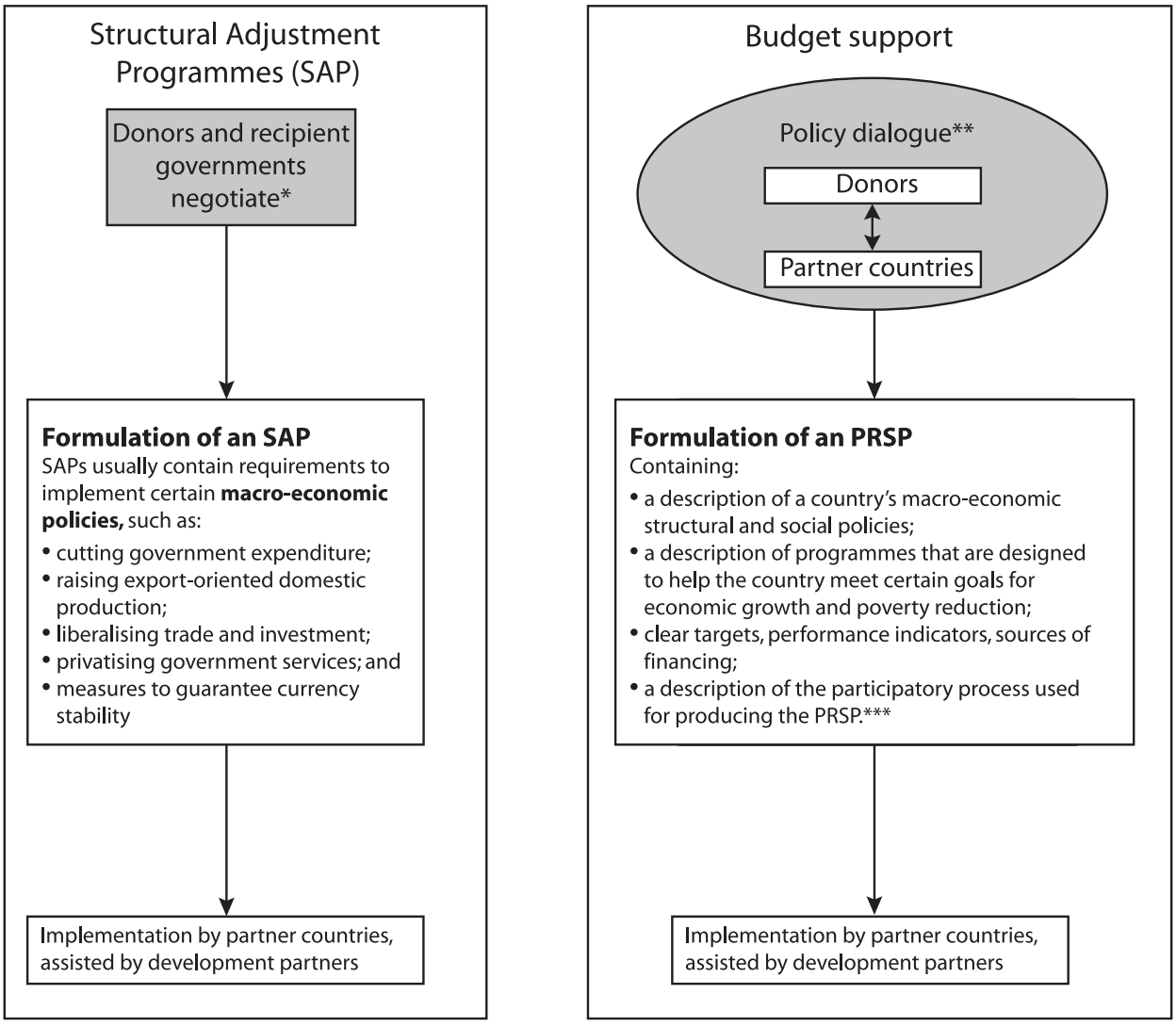
5 Art. 60, Scope of financing; Art. 61, Nature of financing; Art. 66, Support for debt relief; Art. 67, Structural adjustment; Art. 68, Support in cases of short-term fluctuations in export earnings.

6 See, for example, Art. 19 (1), Principles and objectives, and Art. 20, Approach, both of which recognise that development is a long-term process which needs to be promoted through reforms at different levels.

2.3. Intended effects of budget support

From an economic point of view, budget support is basically the same as structural adjustment. Both forms of payment result in a stabilisation of a country's balance of payments. The difference between them is the rationale for making the transfers. While structural adjustment aims primarily at institutional and economic reform, budget support is intended to achieve much wider aims. The overall objective is poverty reduction, which requires the instrument to be linked to the recipient's wider development strategy.[7] The budget support arena may therefore be described as a 'meeting place' for those advocating development from a macro-economic perspective and a development community which has traditionally supported development from the bottom up.

Box 2: Structural adjustment programmes compared with budget support



* Conditions are generally set by donor agencies, often without any elaborate policy dialogue.
** Mutual agreement on conditions, indicators, implementation mechanisms, etc. Where possible, linked to a PRS.
*** According to Brobaeck and Sjoelander (2002:22), a PRSP should contain these four elements at the least

Notes

7 Budget support is also provided in the form of grants to preserve countries' debt sustainability and to encourage them to step up their public spending in social sectors in order to meet their MDGs.

Budget support seeks to tackle key problems emerging from past structural adjustment experience (see box 2) as well as from traditional development cooperation, i.e. the uncoordinated provision of project aid through a myriad of initiatives. In essence, budget support is designed to achieve the following aims:

- to link the provision of external funds to development results. This underlines the importance of a sharper focus on policy outcomes;
- to increase ownership by partner countries by integrating external assistance into the national budget. Budget support thus aims to link aid more closely with local priorities;
- to improve public finance management. The provision of budget support is linked to progressive improvements in this area, which are monitored in relation to jointly agreed indicators;
- to develop coherent and comprehensive national planning and budgeting processes allowing for the rational allocation of resources between investment and recurrent costs;
- to enhance government accountability. Budget support requires regular reporting to national stakeholders (parliament in particular, but also civil society) and external partners;
- to increase the predictability of funding flows to the recipient country, on condition that results are achieved;
- to strengthen national systems for monitoring, assessing and controlling the use of public funds, in particular through public audit institutions;
- to improve the efficiency of aid by reducing transaction costs and through better coordination and harmonisation of donor approaches.

3. EC budget support in practice

The trend towards budget support during the 1990s was led by a number of donor agencies, who shared a common vision for improving cooperation by rationalising the aid bureaucracy and by shifting the responsibility for policy implementation into the hands of the countries concerned. Their view was that policy formulation and monitoring should ideally be undertaken jointly by partner countries and donor agencies. The OECD supported this process,[8] to which the EC actively contributed. The EC was one of the first agencies to define its policy on budget support. The Guidelines for Programming and Implementing Budget Support in Third Countries were adopted by the EC's external aid services in 2002. The EC has also defined a policy on the implementation of sector budget support, published in 2003. Both guidelines apply to all geographical areas in which the EC operates and are tools for harmonising working methods among the various directorates and agencies dealing with development in the EC.[9]

3.1. Approach, practice and challenges

While the EC's overall philosophy on budget support is similar to the views of other donor agencies,[10] there are certain differences in both approaches and implementation practices. These stem from the context in which donor agencies are required to operate, notably the mechanisms for reporting to their constituencies and controlling institutions. Without going into technical detail, the description that follows builds on experiences derived from the ACP region (given that most of the EC's budget support goes to this region). We have distinguished six key aspects in this respect.

3.1.1. Provision of budget support

As spelled out in the CPA, the objective of budget support is to contribute to **macro-economic stability**. The latter is a prerequisite for sustainable growth, the development of the private sector and the growth of employment. In principle, budget support is transferred **directly** to the recipient country's central bank from where transfers are made - using the Ministry of Finance's Treasury account as the sole account - to other government institutions, the private sector and NGOs. Budget support programmes

Notes

8 See, for example, OECD/DAC. 2001. Moving to Budget Support, DCD/DAC/TFDP (2001) 11.

9 The following subsections are based on the two guidelines and the EC note on budget support to the members of the EDF Committee, 30 March 2004.

10 See also Annex 1: Diagram of a budget support process.

are **multi-annual** and generally last three years. Funds are disbursed in the form of **fixed and variable tranches** (see below).

In theory, the EC aims to provide **untargeted budget support**. The rationale is that this will supply the country's general budget with funds that can be spent in accordance with local priorities, and agreed upon up-front between the recipient government and its financing partners. Monitoring and evaluation are based on jointly agreed indicators for measuring output and impact. While there is a clear logic to this untargeted supply of resources for supporting a country's macro-economic development, it is also very ambitious. First, it may be supplied only to those countries which fulfil the eligibility criteria (see Art. 67 of the CPA). Second, it assumes that the partner government can be held accountable by its citizens - primarily through its parliament - and by donors. Third, it presupposes that sufficient local capacity, including systems and institutions, has been put in place to cope with the complexities of budget support. Fourth, it assumes that the operations performed by donors and the partner country are fully harmonised, and that all donors use the same disbursement procedures and common frameworks of indicators and jointly agreed conditionalities.

Most ACP countries do not meet many of the eligibility criteria. For this reason, the provision of untargeted transfers is one of the most keenly disputed issues among the advocates and adversaries of budget support. Where conditions are not conducive to such support, the EC uses sector budget support as an alternative to the traditional project approach to bring about reforms within a particular sector, region or thematic area. The promotion of sector budget support might serve as an entry point for the advancement of local (public sector) reform programmes. This could lead in the long run to the country in question adopting wider institutional and governance reforms, which in turn might permit a move towards untargeted budget support.

3.1.2. Poverty orientation

At the end of the 1990s, the IFIs decided that nationally owned poverty strategies should form the basis for debt relief (a plan known as the HIPIC initiative, see above), soft loans and credits. The aim was to arrive at policies that would focus on economic growth *and* poverty reduction. This focus was put into effect with the introduction of the PRSP process in 1999, which both the EC and most bilateral agencies endorsed. This meant that the recipient partner countries had to prepare a poverty reduction strategy on their own - a well-intended but top-down process - to stimulate 'ownership'. Some countries managed to successfully integrate this approach with their own development strategies - Uganda and Tanzania are often cited as examples in this regard[11] - while others needed substantial support from the IFIs to prepare the papers in question. Most countries have only managed limited achievements in terms of civil-society involvement in the anti-poverty planning and monitoring process. All of this is threatening to turn an approach aimed at 'ownership' once again into a state of 'donorship', as critics observed after the completion of the first round of PRSPs (Oxfam 2004).

Today, PRSPs form the basis of development assistance and soft loans, though they are still very much under development. Most ACP countries are HIPC countries and are required to formulate a PRSP, or at least an initial PRSP, to qualify for debt relief. The EC's acceptance of the PRSP process and the poverty orientation laid down in the CPA informs its policy of providing budget support wherever this is feasible. This type of funding of poverty reduction strategies is also known as *macro-economic support, general budget support or poverty reduction budget support* in EC terminology.

While the donor community has introduced the PRSP concept and endorses its logic of a country-based strategy which needs to be supported from the outside, PRSPs have proved difficult to implement in practical terms.

There are two main reasons for this. First, the aims, targets and performance indicators set out in a PRSP need to be consistent with the country's annual budget. A well-defined **Medium-Term Expenditure Framework** (MTEF) needs to be put in place to bridge any gap. Intense policy consultations need to be held between the budget support suppliers and their partner countries to this end. Ideally, all the partners involved in the provision of budget support should agree on a joint budgetary process, including agreements on targets and performance indicators. However, the practice of dealing with and interpreting the latter in particular

Notes

11 In Uganda, the PRSP process was built on the Ugandan Poverty Eradication Action Plan (PEAP) formulated by the Ugandan government prior to the preparation of the PRSP. This is widely recognised as the reason for Uganda's PRSP success. A similar, albeit less well developed, process took place in Tanzania before the introduction of the PRSP concept.

differs from one donor to another. The EC is keen to harmonise matters and seeks to draw its indicators and targets from PRSPs and the annual reviews linked to them. However, it follows its own line on public finance management issues, which it feels are not properly addressed by PRSPs.

A second difficulty is that the provision of budget support needs to be aligned with the calendar for the **national budget process**. Ideally, the annual review of a PRS should form the starting point for an exchange of views and for taking decisions on how to prepare the budget for the coming year. But experience shows that timing is difficult, as the reviews are regularly dependent on the calendar and requirements of individual donors than on the partner country's budget cycle.

3.1.3. Result orientation and performance measuring
As mentioned above, budget support is intended to promote economic growth *and* poverty reduction. This is reflected by the EC's approach to measuring performance and how this impacts on the transfer of funds. In fact, the EC has developed an elaborate measuring and monitoring system which differs from the practice of other donors and emphasises the EC's result-oriented approach.

EC budget support is released in the form of **fixed and variable tranches**. Both feed into a country's PRS or equivalent national strategies. The **fixed tranche**, known as the 'all or nothing' component, is based on the IMF's Poverty Reduction and Growth Facility (PRGF) review, which assesses whether general conditions, such as a satisfactory macro-economic situation or any specific fiduciary requirements, are in place.[12] In principle, the EC does not undertake any additional assessments and normally disburses budget support immediately after the financing agreement with the partner country has been signed.[13]

The variable tranche is released gradually, depending upon the progress made by the government in meeting the agreed poverty reduction targets (EC: 2004). Where possible, targets are drawn from the PRSP and measurement is usually based on 'outcome indicators' in education and health. Tranches are also released if targets for public finance management are met. The EC is placing increasing emphasis on the monitoring of PFM reform and has produced a set of 'efficiency' indicators in recent years, such as the reliability and timeliness of funding for key basic services. These are currently being tested.

The EC aims to integrate its funding into the local budget calendar and disburses variable tranches after the annual PRSP review. Depending on the assessment of poverty indicators, a payment is made that reflects the country's success in meeting its preset targets.[14] The split between fixed, or conditional, tranches and variable tranches is country-dependent. The ratio in Uganda, for example, is around 50-50, which is also a guide for other country operations. Ratios of 70-30 also occur, however. Some practitioners claim that these are more realistic, as the targets set for the variable tranche are often ambitious and difficult to measure.

While the EC has adopted a fairly detailed approach, the assessment of performance depends on the quality of the indicators and therefore on the robustness of statistical data. In many ACP and other low-income countries, however, reliable data are difficult to obtain. This makes monitoring a very demanding and sometimes even arbitrary exercise for EC delegations. Although staff have been 'deconcentrated' to partner countries largely in order to improve operational capacities in the field for this very purpose, the numbers may still not be sufficient to follow macro-economic and sector reform processes that are both intense and highly complex.

3.1.4. Emphasis on public finance management (PFM)
The European Court of Auditors' special report no. 5/2001 recommended improving PFM as a top priority in order to improve the effectiveness of budget support programmes. It made clear that improvements in this area are not only prerequisites for budget support, but a fundamental objective of direct budget support.

Current procedures suggest that an in-depth diagnosis of the partner country's PFM situation, leading to

Notes

12 Fiduciary requirements in relation to budget support call for funds to be used by the trustee (here, the recipient government) for the intended purposes. This includes the need for proper management and accounting procedures, and the achievement of value for money.

13 There is a degree of variation in practice across countries. With the growing attention given to PFM, the EC has adopted an ad hoc policy of making the disbursement of the fixed tranche dependent on the partner country's PFM being satisfactory.

14 In Tanzania, for example, the EC disburses the variable tranche of the budget support in accordance with the progress made as measured by the performance assessment framework indicators (of which there are around 60 in total). The score for each indicator varies between 0 (no progress), 0.5 (indicator missed, but good progress) and 1 (indicator met). The overall disbursement is the weighted sum of this assessment.

a plan of action, should be undertaken. Countries can qualify for budget support only if the diagnosis shows that they are improving their PFM, a prerequisite which is not mentioned specifically by the CPA. Delegations also need to report twice a year on the PFM situation in the recipient country. An annual assessment is also undertaken, based on:

(i) general public expenditure reviews,
(ii) reviews of the attainment of PFM performance indicator targets,
(iii) the findings of financial audits and tracking studies, or
(iv) recommendations included in technical assistance programmes.

Ideally, this should be done by pursuing a dialogue with the partner government, together with other donors. However, this is a process that comes with high transaction costs for both country officials and delegation staff, and also requires staff at the delegations to possess the appropriate skills.

As a complicating factor, donors do not agree on the definition of an 'ideal' PFM. Individual donor agencies use different assessment tools emphasising different aspects of PFM. The results may lead to very different policy decisions, with one donor agency moving ahead with general budget support, and another finding the situation too risky and going instead for targeted (sector) support or even project support. To overcome such inconsistencies, the EC and the World Bank started a project known as the Public Expenditure and Financial Accountability (PEFA) project about three years ago. This is designed to standardise the assessment of countries' PFM systems, and - once completed - should provide a common basis for policy dialogue on PFM.[15]

Thus, advances are being made in an area that is critical to the successful implementation of budget support. But progress is slow, and requires continuous learning on the part of the institutions involved. Meanwhile, substantial amounts of resources are flowing into the system. In fact, the approach adopted presupposes that the system can only be overhauled while in use. As one advocate formulated it, 'if you want to find a leak, you need to fill the system with water.' This is an interesting analogy, in that the question is whether it is possible to monitor all the pipes in the system and hence whether water should be introduced into the system at all, and if so, how much water this should be.

3.1.5. Donor coordination, and donor-partner country coordination

The above underlines that the success of budget support depends greatly on the quality of interaction between the various partners involved. Budget support resources entering into a system are fungible (see Box 4, section 4) and can in the end only be initiated, managed and monitored by means of a joint approach that takes account of the big picture. Coordination and alignment are easier if a partner country can take a lead in guiding the partners. In the absence of strong partner country leadership (which can inform, orient and control the donor community), good coordination of the donor agencies is essential.

Donor agencies that support budget support subscribe to its principles but still try to bring in, where possible, "their own" views, interpretations and convictions on how budget support needs to be provided. This becomes most evident in their approaches to institutional and public financial management assessments (as discussed above) and to monitoring, in particular in the way they set and interpret indicators. The EC is very much part of this process.

A solution to these problems may be lie in developing and formalising 'joint partnership frameworks' between the government and its partners. The EC is an active member of such partnership frameworks. In the ACP region, there were budget support groups involving different donors in ten countries in 2004;[16] their task was to outline basic principles and processes and to define a framework for performance assessment. The principle of a joint framework is explained in Box 3 (which takes the Tanzanian initiative as an example), and provides a glimpse of the complexities involved in moving towards coordination and harmonisation (based on information from EC 2004, and Daima and ODI 2004).

Notes

15 The initiative has now evolved into a partnership between the World Bank, the EC, the UK, France, Switzerland, Norway, the IMF and the Strategic Partnership with Africa (SPA).

16 Benin, Burkina Faso, Ethiopia, Ghana, Malawi, Mozambique, Rwanda, Senegal, Tanzania and Uganda.

Box 3: Donor-government coordination in Tanzania

Since September 2004, the Poverty Reduction Budget Support (PRBS) Group in Tanzania has been made up of 14 members: the African Development Bank, Canada, Denmark, the EC, Finland, Germany, Ireland, Japan, the Netherlands, Norway, Sweden, Switzerland, the UK and the World Bank. It was formalised in its current form under a Partnership Framework agreed in 2002. The government of Tanzania asked for all budget support to be provided through the PRBS. In 2004, PRBS together with the World Bank's Poverty Reduction Support Credit (PRSC) accounted for 25% of aggregate aid. It is delivered as direct, non-targeted budget support.

The Partnership Framework describes the process and a Performance Assessment Framework (PAF) sets out the agreed policies and expected actions. These are assessed in a six-monthly joint review. A number of Poverty Reduction Strategy (PRS) indicators (related to the Millennium Development Goals) which were added to the PAF are still under discussion. The PAF focuses primarily on PFM and macro-economic issues. But the link to poverty reduction is gradually growing as the PRS indicators are introduced, and views from the World Bank's PRSC, namely in relation to considering progress on rural development, are included.

Work is still very much in progress. The PRBS needs to be aligned more closely with the review of Tanzania's PRS and linked with the government's budget preparation process if the gaps between the PRBS and the PRS are to be bridged. Moreover, the decision-making mechanism of the PRBS reviews has not been formalised, and individual financing agreements take precedence over the Partnership Framework. This is a potential cause of problems.

3.1.6. Capacity development

Obviously, there is a huge capacity agenda linked to the issue of budget support. Capacity improvements need to take place within donor agencies - both at headquarters and in the field - and between donor agencies and within partner countries.

The EC recognises this and places considerable stress on the need to build and strengthen capacities for the planning, management and control of budget support and sector reform activities. These include:

- support for public finance and information systems;
- building capacities for budget programming;
- strengthening internal and external audit capacities and institutions, including parliamentary control and surveys; and
- technical support for line ministries aimed at enhancing their ability to link sector policies with macro-economic planning and budgeting.

The EC also supports national statistical and monitoring institutions. There are plans to use between 5% and 10% of the funds available for budget support for capacity development. So far, no data are available showing that this ambitious target is being met.

Although the EC has initiated intensive training in budget support for its headquarters and field staff, more needs to be done. The offices of the National Authorising Officers, most of which are based in the finance ministries of ACP countries, need to be fully able to deal with budget support, as do other central institutions of the recipient governments. Equally important, however, is capacity development among donor organisations, so that they can learn from each other's approaches, harmonise their day-to-day operations with governments, and overcome institutional rivalries and competition.

Finally, there is a governance dimension to budget support. As parliamentary control is often too weak, civil society has a role to play to accompany the process, for example by participating actively in general or sector-specific poverty reviews. These need to be seen as an inherent part of budget support as funds are channelled to fuel PRS. Capacity development efforts thus need to recognise the role that non-state actors can play in a wider process of institutional reform. These actors should be equipped with the knowledge and skills they need to take on this role.

3.2. Facts and figures[17]

3.2.1. Trend towards budget support

When the Lomé IV Convention entered into force in 1990, the European Community joined international efforts under the leadership of the IFIs to restore economic equilibrium and to contain or reduce external debt in ACP countries. As of the 7th EDF (1990), it created a structural adjustment facility for the payment of General Import Programmes. As of the 8th EDF (1995), this was changed into direct budget support for countries with convertible and freely transferable currencies.

By the end of 2000, the Community had committed €3,183m and disbursed €2,320m to 42 ACP states through the structural adjustment facility (European Court of Auditors, 2001: 4). Some ACP countries received the lion's share of their EDF allocation through this facility during the period from 1990 to 2000: Benin (60%), Burkina Faso (57%), Grenada (55%) and Mauritania (50%) are cases in point. Overall, some 30% of the 7th and 8th EDFs was disbursed as structural adjustment grants, which meant that a large amount of funds were made available without being linked to intense policy dialogue and donor coordination. However, only 24% of total assistance to these 42 ACP countries was committed as structural adjustment support, which implies that actual disbursements through structural adjustment support were higher than planned (idem: 4 & 19).

Similar mechanisms were introduced for other regions receiving EC external assistance. For instance, between 1992 and 2000, the Commission committed €955m to a structural adjustment facility under its MEDA programme, which amounted to 37% of the total funds available as EC assistance to the countries in question (idem: 6).

3.2.2. Current EC budget support

The EC tested the use of budget support in Burkina Faso and started using this new aid modality in various ACP countries in 2001. The EC has stated that, as regards the 9th EDF (with a total value of €13,800m), around 30% of the country A envelopes - the total country allocation minus a certain sum withheld to cover unforeseen needs (B envelope) - has been earmarked as general budget support (EC 2004a: 3).[18]

Since budget support was introduced in 2001, a number of trends have taken place in terms of earmarking, commitments and disbursements. As no comprehensive statistics are available, the figures can do no more than provide a snapshot of a rapidly changing situation:[19]

- In March 2004, the total amount approved for disbursements under ongoing budget support programmes was close to €1,700m (i.e. some 11% of the total value of the 9th EDF).
- A large fraction of these funds stems from previous EDFs (disbursements between 2001 and 2003 increased slightly from €318.3m (2001) to €406.23m (2003) out of a total of €1,109.54m for the whole period). Disbursements under the 9th EDF did not start until 2003, which means that a large portion of the 30% target set for the current EDF has not yet been met.
- The largest recipients of EC aid in the form of budget support until 2003 were Tanzania (€131.4m), Mozambique (€136.6m) and Zambia (€ 109.6m), while the largest commitments for this period were made to Mali (€164.66m), Burkina Faso (€149.2m) and Tanzania (€190.13m). Disbursements to some Francophone countries have not grown as quickly as those made to East and Southern African countries. Whether this is a trend and whether this applies to all Francophone countries is a matter that needs to be monitored.
- The countries receiving the largest shares of EDF funds committed in CSPs to be disbursed through budget support are the Democratic Republic of Congo (65%), Burkina Faso and Ghana (55%) and Mozambique (45-55%).
- All committed general budget support operations

Notes

17 Quantitative information on budget support should be read with care. Donors use different definitions and accounting techniques and there is a great deal of confusion about the distinction between general and sector budget support. IMF tables on budget support, for instance, include data on programme aid, which may in turn include aid flows that are earmarked for specific sectors or even specific expenditure programmes. Although EC statistics aim to distinguish clearly between budget support and sector budget support, not all statistics consulted for this paper are consistent in this regard. The EC's operational practice is even more complex. There is a tendency to describe as budget support a number of cases which would perhaps be better defined as programmes, because the two designations imply different procedures, with the latter being seen as more cumbersome than the former. Such practice can speed up the release of funds and reduce disbursement pressures.

18 The EC recently started to provide budget support to MEDA countries. The EC is currently preparing a full overview of budget support to various regions. This information was not available, however, at the time this paper was written. The provisions of the 1992 ALA regulation (443/92) do not foresee the use of budget support. The provision of macro-economic assistance is thus not built on a sound base of policy dialogue and donor coordination.

19 The following figures are all based on EC 2004a: 2-4, and Annexes.

contain an institutional and capacity-building element of around 10%. No figures are available on the implementation of this element.

In addition to general budget support, the European Commission is currently implementing 11 sector budget support programmes in ACP countries. These are worth a total of €393m.[20] Some of these sector support programmes are treated similarly to general budget support. Uganda, for example, receives around €35m from the 8th EDF through budget support for the education sector. Although this is registered as sector budget support, it is treated as general budget support for operational purposes.[21]

4. Views on EC budget support

4.1. European voices

4.1.1. Member states and the European Parliament
Budget support is a controversial topic among ***European member states***. Basically, there is a north-south divide between those countries which favour the use of budget support in principle (primarily the UK, Ireland, the Scandinavian countries and Finland, the Netherlands and Switzerland) and others who are against it. The Southern Europeans are the fiercest opponents, while countries such as Germany, France and Belgium may be described as very cautious supporters. Budget support has been the butt of considerable criticism, both from within Europe and from other parts of the world, because it is perceived as being fungible (see Box 4), as potentially corrupt because of the limited scope of its control mechanisms, as leading to the replacement of well-planned projects and programmes with massive and untargeted transfers, as reducing the visibility of national cooperation efforts, and as supporting the untying of aid.

Box 4: Fungibility - a problem inherent to budget support?

In a way, all aid is fungible as support for specific sectors or programmes does not automatically lead to the partner country spending more on the same activities. The empirical evidence suggests that targeting aid on one (social) area results instead in the government spending more on an area that is not supported by donors. Only an intense policy dialogue between donors and the partner country can result in a poverty-oriented budget allocation. Fungibility is not necessarily a bad thing, as Foster et al. note (2004). The government of Vietnam, for example, asked donors to take on funding for big infrastructure projects. This had the effect of releasing government funds that could then be used for reducing poverty and improving social indicators.

Such views are reflected in the criticisms voiced by the ***European Parliament***, which spring from a mix of concerns. First, genuine concerns have been expressed about the use of budget support, particularly by representatives of Southern European countries and countries which are hesitant supporters of budget support. Second, there is dissatisfaction among members of the European Parliament about the institutional context in which the EU funds development cooperation. Budget support provided under the CPA is channelled through the 9th EDF, which is not part of the general Community budget and is therefore not under the European Parliament's control (the same was already true of the balance-of-payments support provided under the 7th and 8th EDF). The EDF is separately funded by member states, covered by its own financial regulations and managed by its own specific committee.[22] This is a highly controversial situation, as is illustrated by the ongoing debate on 'budgetisation'.[23] Budget support provided to non-ACP countries is controlled by the European Parliament's Development and Budget Control Committee (BCC).

Notes

20 Sector budget support is relatively infrequent in ACP countries, where only 11 out of 40 sector operations are using budget support as a disbursement mechanism, compared with 6 out of 21 in Asia, 5 out of 12 in MEDA and 5 out of 5 in ALA countries.

21 All figures are based on EC 2004b: 4-5, and Annexes.

22 The EDF Committee consists of experts from member states, and is chaired by the European Commission. The Committee takes no decisions, but votes to give a formal opinion on each financing proposal. The European Commission normally decides to go ahead after receiving a positive opinion from the EDF Committee. If the Committee votes to reject a financing proposal - which is a rarity - the Commission can then submit the proposal to the European Council.

23 This issue has nothing to do with the budget support mechanism. 'Budgetisation' refers to a situation in which EDF funds are brought under the general Community budget. The Commission has proposed discontinuing the EDF after 2007 and making all aid to ACP countries subject to mainstream cooperation instruments. The ACP countries are fiercely opposed to such a move. See also Mackie et al. (2004).

The European Parliament's views on the risks of providing budget support were most strongly expressed in its session of March 21 2003, in which it invited *'the Commission to keep the use of budget support to a minimum until it has evidence that public finance management in beneficiary countries is of such a standard that the inherent risk of the budget support approach has been considerably reduced'* (European Parliament, 2003: 14). The BCC again expressed its concerns during a debate on 26 January 2004 on the annual discharge of the Commission from its responsibility for the management of the EDF. The BCC called for further discussions with the EC on how to improve the monitoring and evaluation of budget support and sector budget support.

4.1.2. The European Court of Auditors

Whereas the European Parliament is relatively critical of budget support, the ***European Court of Auditors*** has given its support in principle to the shift from old-style macro-financial assistance to budget support. Its Special Report no. 5/ 2001 notes certain weaknesses under the old structural adjustment support system in the targeting of budget expenditure at poverty reduction, the allocation of funding, the process and quality of auditing, the use of technical assistance and the European Commission's internal capacity for handling budget support. Against this background, the Court stressed the need for the EC to closely monitor the quality of public financial management in partner countries, improve the volume and regularity of social sector expenditure, and improve programmes in close coordination with all parties concerned. The EC's policy on budget support has been finalised and adopted in response to these recommendations.

4.2. Peers and observers

This section is limited to a number of key cross-cutting observations on the practice of EC budget support derived from interviews, critical reports and evaluations. Detailed views on individual country operations are not included.

4.2.1. Investments in knowledge and learning

The EC plays a prominent role in advancing the principle and use of budget support in the international arena. While critical views have been expressed about the speed of budget support for ACP countries, the amounts involved and the way in which budget support is monitored (including the use of indicators), peers appreciate the substantial changes which their colleagues from the EC have introduced and promoted in recent years. As one of the first donors to embrace this modality, the EC has produced detailed guidelines on the programming and use of general and sector budget support. The EC has also combined the deconcentration of officials to country delegations with an elaborate staff training package, and is an active member of international expert working groups addressing the problems, both conceptual and operational, associated with budget support. It has been particularly keen to harmonise the indicators for education and health.

The criticisms of budget support and the questions raised about the extent to which it has actually reduced poverty have encouraged donors to conduct thorough reviews of its effects. The EC has built on preparatory work financed by the DfID on the evaluability of budget support (OPM/ODI, 2002), which aimed to assess:

- the extent to which a partner government can be empowered in its relations with donors (in the short term);
- how budget support can transform the quality of governance (in the medium term);
- how budget support can enhance a government's capacity to reduce poverty (in the medium to long term); and
- what its effects are on poverty reduction in the long term.

Budget support is currently being evaluated in eight selected countries, under the aegis of the OECD/DAC. The review is backed by several donors providing budget support, including the EC, and makes use of a Joint Evaluation Framework. The findings are expected to be published in 2006.

4.2.2. Process versus results-based monitoring

The EC has a reputation for a strong result orientation. This is understandable, given the criticisms expressed by the European institutions (see above). The sharp focus on result-based management, however, is not shared by a number of other donor agencies, who regard the EC as too rigid, inflexible and not capable of adapting sufficiently to local circumstances. Doubts have also been raised about the focus of performance monitoring (an issue which applies to other donor agencies as well). An evaluation of EC support for the education sector in ACP countries notes that performance monitoring tends

to be restricted to financial indicators when budget support for the education sector is assessed (Europe Aid: 2002). As a further point, the multi-dimensional nature of poverty means that activities other than health, education and PFM alone also need to be monitored (Lehtinen: 2002).

One of the main points raised by those favouring a process orientation to performance monitoring[24] is the absence of reliable data for measuring results in most low-income countries. Although organisations responsible for collecting and synthesising data receive institutional support, they are far from being able to produce reliable statistical evidence. Moreover, donors tend to overestimate partner countries' ability to exert any substantial influence over changes. In fact, most countries receiving budget support are in a transitional period. This means that their ability to take initiatives, such as undertaking what are sometimes difficult institutional change processes that will enable budget support to be used in the longer run, are of key importance and are often the only way of 'measuring' change. It is often unrealistic to expect them to achieve concrete results within a short space of time.

The current donor thinking on budget support draws heavily on experiences in Uganda, where the statistical data is of a higher quality than in other countries in the same region. Uganda also enjoys a high level of donor coordination under strong government leadership - a situation in which different views on results monitoring can be dealt with more constructively. In the absence of such conditions, a result-based approach is relatively impracticable and can militate against joint coordination efforts. The EC recognises these realities, and there are signs that it is adopting a more flexible position in countries where the situation does not permit otherwise. Generally, however, the EC is reluctant to adopt such an approach more broadly (see Box 5).

Box 5: Harmonisation in Practice (HIP)

Early in 2004, a number of HIP donors (i.e. Ireland, the UK, Denmark, Sweden, Finland and the Netherlands) agreed on the use of a standardised Joint Financing Arrangement (JFA) for operations in various countries. The aim of this initiative was to agree on a common financing approach internationally, but to leave sufficient flexibility to adapt to country-specific conditions and the operational concerns of individual donors. The template for the JFA states that common goals need to be agreed upfront before joint financing is provided; states how to measure progress towards set goals; and shows how donors can pursue a dialogue with governments. The template does not, however, specify the type of indicators, an issue which is left to the respective country MoUs. Finally, the HIP donors agreed that country-specific exceptions to MoUs (which might be needed for bilateral operations) should not contradict the contents of the general Template. The practicality of the JFA still needs to be tested. Although the EC did not join the general HIP initiative, it has adopted a policy of taking a case-by-case decision on whether or not to join other donors for specific countries. It has decided to sign up to the MoU formulated by the HIP donors, other donors and the government of Mozambique, and is participating in joint partnership framework initiatives in 10 partner countries (see section 3.1.5. above).

4.2.3. Public finance, regulations and capacities

EC Country Strategy Papers (CSP) and Country Strategy Evaluations on South Africa, Malawi and Uganda provide some additional insights into the potential and effectiveness of budget support. The CSPs show that budget support is still in the planning stage in many countries. A move from structural adjustment programmes towards poverty-oriented budget support needs to be carefully planned, as a number of CSPs have stressed. Country Strategy Evaluations make clear that essential preconditions need to be in place before budget support can be provided. Expectations are often unrealistic and overoptimistic. The CSE for Malawi states that this financing mechanism is unlikely to be practicable unless problems relating to fiscal stability and ***public financial management*** are resolved.

Notes

24 In this context, performance is understood as meaning process outcomes, such as advances in policy formulation or the constitution of new institutional mechanisms, as much as hard outcomes.

In South Africa, sector budget support appears to becoming a favoured method for financing poverty reduction activities. However, the evaluation states that an overdose of ***rules and regulations*** imposed on EC delegations is hampering effective implementation and preventing the adoption of harmonised procedures shared by all donors. Similarly, the CSE on Uganda points to the extreme complexity of EC procedures as a factor that is preventing the successful use of budget support. Whilst peers in the field recognise that the EC has made substantial changes to its operations, its bureaucracy is still perceived as being too slow and cumbersome to enable it to keep pace with other donors.

The EC is currently finalising the process of deconcentrating powers to partner country delegations. This is a timely measure, as ***staff capacities*** need to be in place to implement and monitor operations more closely. The delegations will have a demanding agenda, as they will need PFM capacities, detailed sector knowledge, policy analysis skills, and facilitating and negotiating skills. There is a risk, however, that the trend towards budget support as the preferred modality and the accompanying emphasis on PFM risks strengthen capacities in an unbalanced manner. If macro-economic reform and poverty reduction both remain the aim, as budget support postulates, the EC cannot disengage from monitoring developments and processes at sector and sub-sector levels. This requires the presence of specialists, which is an issue that has not yet been addressed by the deconcentration process. A large proportion of new posts have been created for contract management and finance staff at the delegations. Only a small number of people have been recruited who possess the expertise required to work on substantive aspects of development cooperation (Frederiksen and Baser, 2004). One solution might be the delegation of monitoring responsibilities to other donors. The CSE on Malawi notes, for example, that, if budget support is adopted, the EC will have to rely on lead donors in health and education monitoring progress, since the EC delegation does not possess the requisite sector knowledge and does not receive sufficient support from its headquarters.

4.3. What partner countries say

This section brings together partner country views on budget support from a number of sources. Very few systematic reviews have been conducted of partner country views on budget support and their assessments of its risks and opportunities.

4.3.1. A plea for budget support

The practical evidence suggests that a government's decision to accept budget support from its partners springs largely from the country's general economic and poverty situation. Countries which go for budget support are those which possess the weakest public sector management capacities, and this causes donors to focus their attention on accountability and policy dialogue. If a country is less dependent on budget support, it might choose to refrain from the complex policy dialogue processes that come with budget support and opt instead for targeted and less 'dialogue-intense' project assistance for areas in which the government is unable to deliver.

The Tanzanian government has made a careful assessment of the risks and opportunities associated with general budget support. The President's statement to the World Bank-chaired Coordination Group Meeting in 2001 and the 2002 Tanzania Assistance Strategy (TAS) both make a clear choice in favour of joint action by government and donors, the harmonisation of procedures, the untying of aid and the pooling of resources into 'basket funds' to be executed under government leadership. According to Aarnes (2004), government officials argue that only a move towards general budget support can help to reduce transaction costs and process overload, channel all resources into the budget process and make it subject to parliamentary control. This is an understandable claim, given the highly fragmented state of the aid apparatus, with over 50 cooperation agencies undertaking over 1,000 missions and asking for over 2,000 reports each year (WB 2004: 207).

The advantages of budget support were also recognised during the Strategic Partnership for Africa (SPA) meeting held in Tunis in 2003. A survey held among donors and the African partner countries on alignment, harmonisation and coordination with regard to budget support presented a mixed picture. Partner country representatives said they valued budget support because its untargeted nature allowed them to make rational budget allocations between investment and recurrent costs, as well as between different sectors. Project funding generally favours the financing of investment costs linked to a specific sector, whereas operational costs - which cannot be funded from national revenues - remain unfunded. But the review also showed that the average level of satisfaction with the progress made on alignment was not very high.[25] While improvements in coordination have been noted, the steps taken towards

Notes

25 The term 'alignment' refers to donors anchoring their support in a developing country's objectives, priorities, and policies, based on a consistent set of result indicators, and aligned with the country's processes, systems, budget cycles, etc. (definition taken from CIDA, 2004).

harmonisation and alignment have not led to a reduction in transaction costs. The strengthening of government capacities and systems, in particular where PRS processes are young, needs to be prioritised (SPA: 2004). These views are also supported by National Authorising Officers (NAOs), though opinions on budget support vary from one country to another (see Box 6).[26]

Box 6: Points raised by NAOs on budget support

- NAOs identified budget support as one potential way of speeding up EDF disbursements. They generally welcomed the more widespread use of budget support.
- Experiences with direct budget support have been mixed. Some countries feel that procedures are too cumbersome, and that excessively strict conditions are imposed. It will not be easy to reach agreement on an MoU financing agreement with the EC.
- Countries benefit from result-oriented budgeting, including regular quarterly reviews and the publication of results.
- The existing tranche system, under which successive tranches may be disbursed only if positive audit opinions and evaluation reports have been issued on the preceding tranche, are vulnerable. There are two reasons for this: (i) the cumbersome nature of procedures, and (ii) the fact that auditors and consultants are not always recruited in good time.
- EC assistance should not be made subject to other donors' rules and conditions. There have been cases in which agreement has been reached on projects to be financed by the EC, but where these have subsequently been rejected in the wake of objections raised by the World Bank.
- Procedures, rules and indicators should be harmonised.
- There is a need to collect and share ACP countries' experiences with direct budget support.

4.3.2. Conditionalities

The provision of budget support is accompanied by an intense policy dialogue which normally goes beyond strictly technical, administrative or logistical aspects. Governance issues, such as the relative absence of partner government spending on social sectors while budgets for military spending are on the rise, can bring sensitive political issues to the table. There is a risk of a perception of donor intrusion and politicisation if there is no clear up-front agreement among all partners about their respective obligations and responsibilities, as well as about the conditions and indicators they wish to use. The risk of donors sliding into politicisation is particularly high in countries where parliamentary and civic control is weak - which is the case in most countries receiving budget support. A critical review of general budget support in Tanzania, for example, states that recipient officials - despite their general appreciation of budget support - feel that the policy dialogue with donors is 'intrusive' and increasingly linked to a political agenda, beyond the technicalities of the budget support mechanism (Frantz: 2004).

Overall, the following pattern seems to emerge. Due to the withdrawal of donors from the operational side, partner countries acquire greater control over the details of programming and project implementation, and this can enhance their ownership. At the same time, however, countries lose some measure of autonomy over the overall budget allocation process because of the close involvement of donors through dialogue and a certain push towards accepting and executing wider reforms at the macro-level by the partner government.

There are also worries that governments may become subject to political pressures and leverage exercised through joint donor approaches. This is sometimes referred to as the risk of 'donors teaming up', and is a realistic concern. In Kenya, the EC suspended the transfer of a €150m grant into the government's treasury after the British High Commissioner made allegations of corruption.[27] In Uganda, donors expressed their dissatisfaction with the increase in funding for the military in 2004, and the UK blocked €14.6m in 2003-04. The EC is contemplating cutting development assistance for the same reason.[28]

The CPA envisages an ongoing process of political dialogue between the EU and the respective partner

Notes

26 From six regional workshops for NAOs, RAOs, non-state actors and EC staff, organised by the ACP Secretariat in Gabon, Ethiopia, Senegal, Surinam, Samoa and Botswana in 2004.

27 The Guardian Weekly, 30 July to 5 August 2004. In November 2004, the EDF Committee decided to unlock the transfer under the strict condition that the Kenyan government demonstrated a genuine commitment to economic reform as defined in the Economic Recovery Strategy and that there was an improvement in the standard of public financial management (East African Standard, 27 November 2004).

28 European Voice, 23 September 2004.

governments. The most basic conditionalities are set out in Art. 9, which states that cooperation will not take place unless *essential elements*, such as democracy based on the rule of law and transparent and accountable governance, are respected. The Agreement also states that sustainable development can be achieved only if these issues and others, such as development policies, are pursued by the government. If the political dialogue breaks down, there are provisions for more formal consultations on the application of the *essential elements* (Art. 96 and 97). This may lead to the EU imposing harsher conditions, such as the suspension of a cooperation instrument, for example budget support.

However, because budget support plays a prominent role in macro-economic stabilisation, the threat of freezing or even cancelling it gives donors a degree of leverage that few other instruments can deliver. Weaker partner countries such as Mozambique are particularly fearful of such 'stop and go' tactics, as they are affected most by the resulting unpredictability of disbursements. The EC's policy of making payments through a mix of fixed and variable tranches may be seen as an attempt to reduce this tendency and to increase predictability (the fixed portion is 'guaranteed' and is transferred as soon as the IMF-PRGF assessment shows a green light; see section 3.1.3.).

4.3.3. Capacities

Partner countries are ill prepared to follow up on all policy dialogue processes. First, many officials dealing with budget support are technocrats with limited influence over policy or for that matter political level. Policy dialogue touching upon governance is beyond the scope of their work. Second, many partner countries do not possess sufficient technical and dialogue capacities for dealing with complex processes such as budget support and sector budget support. This results in a dialogue process that is poor in both quality and effectiveness.

The CSE for Uganda points out that the conditions set by the EC did not help to reduce poverty in any significant way. The multiplicity of procedures and conditionalities set by the EC did, however, divert valuable government staff resources to cumbersome bilateral discussions. Reviews and assessments imposed bilaterally by the EC rather than jointly by all donors of budget support placed a considerable burden on the limited capacities of Ministry of Finance officials (IDC/DS 2001: 34).

Capacity strengthening is required both within and beyond central government institutions. During various parliamentary seminars in ACP countries co-organised by the ECDPM, parliamentarians called for more attention to be paid to governance and for the legislature to be strengthened, in particular in the area of institutional capacity development and information provision (Corre, 2004). As the EU increasingly moves towards budget support, the governance of this mechanism requires a balanced and well-informed dialogue between the legislative and the executive branches of government. Thus, parliaments need to have access to the resources and knowledge they need in order to perform their role properly.
A similar demand emerges from experiences of civic monitoring of poverty processes. Civil-society representatives who participate in poverty review processes need to be aware of the complexities of this aid modality. It requires an improved capacity for policy dialogue and a better understanding of macro-economic mechanisms.

5. Thumbs up or down?

Budget support is a relatively new aid instrument that could radically transform the way in which international development cooperation is delivered.
A judgement of whether budget support is useful and effective can only be made once we have been able to perform a more thorough analysis of the experiences to date. The ongoing evaluation of budget support is highly relevant and timely in this regard. While it is too early to formulate conclusions and recommendations, we will briefly list a number of emerging lessons that guide current thinking on this instrument. Specific comments on the EC's policy on and use of budget support are highlighted where appropriate.

5.1. Issues under discussion

Donor coordination: There is a consensus that the introduction of budget support has encouraged donor agencies to work together more closely, in both conceptual and operational terms. The greatest positive impact has been seen in those countries in which a critical mass of like-minded agencies is gathered under the leadership of the partner country's government. Although the EC has consistently sought to strengthen the ability of its headquarters

and delegations to coordinate and manage budget support, it is not clear whether enough has been done to meet the challenges.

Progress has generally been fragmentary, however, in those partner countries in which there is no critical mass of donor agencies in favour of budget support, combined with a partner government that is either unwilling or unable to implement budget support. Progress has also been slow in fragile countries, and in countries where the cooperation agenda is dominated by political considerations or arguments relating to natural resources. In such countries, donor agencies have much fewer opportunities to turn what are often both corrupt and low-capacity governments towards a reform agenda of harmonisation and alignment.

Harmonisation and alignment: The successful use of budget support requires funds to be supplied on time, in a predictable manner and in accordance with the government's budget cycle. Ideally, the integration of external support into one government-led public administration and governance system requires donor agencies to stop favouring or using their own systems and to align their policies and procedures with those of peers and governments. Unfortunately, there is a long way to go before full alignment is achieved. The SPA review showed, for example, that some countries need to accept up to 10 different donor missions in order to get their public finance management system assessed.

The review also revealed that donors ask virtually all partner countries to report on performance indicators which are not drawn from the PRSP (SPA: 2004). Work is very much in progress on this issue and massive efforts are being made to harmonise, as our information on the 'joint partnership frameworks' showed. The EC is an active partner in this process and has taken the lead in defining harmonised indicators for health and education. It favours making maximum use of PRSPs as a starting point for its performance indicators. Although this is logical enough if budget support is to be linked to the poverty agenda, other donors have not yet followed the EC's example. The EC is more reluctant to harmonise its practice with other donors on approaches which could risk undermining the EC's orientation towards result-based monitoring.

Result-based management: Whilst neither donors nor partner country governments dispute the importance of a focus on results, the lack of high-quality data has led donors to adopt a range of different approaches to date. The EC's view is that the different 'camps' will move closer together over time, as more and better statistics for monitoring poverty become available. But it will take a long time to build adequate professional and institutional capacities in the partner countries so as to guarantee the regular and timely production of reliable statistics. In the eyes of some donors, this warrants adopting a process-oriented approach for the time being instead of a result-based approach to the monitoring of budget support focusing on hard outcomes. The EC does, however, offer a framework for monitoring which donors who are presently critical of budget support can join once factors such as statistics improve. It has thus created a conceptual 'middle ground' so that donors can potentially agree on a common future approach.

Public finance management (PFM): Following the publication of the European Court of Auditors' special report no. 5/2001, PFM became central to the EC's policy on budget support. The report recommended regarding PFM as a fundamental objective of the provision of budget support, and not just a prerequisite. In the meantime, several donors have embraced this logic. Despite this, there is still no broad consensus on the definition of an 'ideal' form of PFM. The EC regards this topic as being of key strategic importance, not only for the effective provision of budget support, but also more widely for the partner country's development. This is illustrated by the fact that the EC is the largest financial contributor to the multi-donor PEFA Secretariat (see section 3.1.4.) for the development of harmonised PFM assessments of partner countries.

Enhancing government capacity to reduce poverty: Initial experiences in Uganda and Tanzania suggest that the new paradigm gives partner governments greater latitude in which to take decisions on policy issues and implementation. This has led to an empowerment of government capacity to manage the donor community and to take ownership of the country's development strategy, in particular in fields such as health and education. Budget support is provided on condition that financial management is improved. This in turn helps to enhance government capacity in planning and PFM. The extent to which

this approach can improve overall government capacity to reduce poverty remains to be seen, as change processes last very long, possibly much longer than many supporters of budget support might expect.

Transaction costs: The principle of budget support suggests that transaction costs can be substantially reduced in the long term, which is why the EC considers it one of the most efficient forms of international cooperation. Experience to date has failed to corroborate this. The replies of partner governments provided for the SPA review suggest that harmonisation and alignment have *not* cut transaction costs across the board. This is also the observation of Killick (2004), who claims that the rhetoric on transaction costs is not sufficiently evidence-based. Preliminary observations from partner countries suggest instead that costs in partner countries are in any event shifting towards the centre, mostly from individual sectors to finance ministries.

Donor agencies also need to invest heavily in country delegations to keep pace with a rapidly changing aid environment. This requires different skills, notably in policy analysis and monitoring, PFM, facilitation, networking and dialogue. But it will be difficult to maintain the EC's decision to focus mainly on the macro-economic level, given that the preliminary experiences from delegations suggest that close monitoring of processes at sector, intermediary (or meso) and micro levels is required. There is a risk that a focus on macro-economics and public finance management will simply overlook key vertical linkages and horizontal developments. The need for a qualified "poverty monitoring" at the EC's delegation level is pressing. This requires investments in health and education in particular, given the EC's strong focus on developments in these sectors. More expertise in the field to better understand and support cross-cutting issues like governance, civil society and gender is equally indispensable.

Mix of instruments: Critical observers of budget support point to the potential for misuse caused by an uncontrolled supply of funds, and to the speed of operations channelling substantial resources into ill-prepared institutional settings. While these observers recognise the general principle and the potential positive aspects of budget support, they have called for a more balanced approach involving a mix of instruments, including project support for sectors, local government and civil society in addition to budget support. In the case of Tanzania, Frantz argues, for example, that we should re-examine the recent focus on central institutions and consider using a range of mechanisms alongside each other so as to meet the needs of different parts of society (Frantz: 2004). The downside to such an approach - as supporters of budget support point out (Aarnes: 2004) - is the absorption of scarce local capacities into a still fragmented aid environment at the expense of national government leadership.

Transforming accountability and governance: In theory, budget support can promote the use of new accountability mechanisms, leading to improved governance. The payment of funds into the partner country's Treasury should help to improve accountability within government. The finance ministry - which has to report to the outside world - has an interest in seeing sector ministries getting results, and sector ministries have an interest in ensuring that sufficient funds are allocated on a regular basis. A precondition, however, is that there must be a transparent PFM system in place of an acceptable international standard to support these institutional interactions and negotiations.

The EC's decision to link the provision of budget support to the poverty process by drawing on indicators formulated in PRSPs (insofar as is possible) is a move in the right direction as regards accountability and better governance. The approach assumes that annual reviews of a country's PRS will create a mechanism for reporting to the media and citizens, in addition to presenting and debating the results of the poverty reduction effort in parliament.

Obviously, there is a very long way to go in order to build such a web of accountability relationships. Annual PRS reviews are not performed systematically. Where they are, budget support is not aligned closely enough with the PRS to allow for effective monitoring. In addition, parliament and civil society are generally lacking in capacity and are badly informed, and often do not have the political weight that is required in order to advocate more poverty-oriented policies. Moreover, it is very unclear how governance in partner countries will develop over time. Budget support is likely to have a positive impact on accountability and governance only in the medium to long term, if at all.

Conditionality and policy dialogue: Following the experiences with structural adjustment programmes in the 1980s and 1990s, there is a general consensus that conditionality - as practised in the past by the World Bank and the IMF - will not lead to improved policies. Together with a number of other donors, the EC has called for an end to policy conditionality and the adoption of a result-oriented approach, based on the PRSP process. While this approach has the advantage of being built on (intended) local poverty-reduction strategy formulation processes, instead of on externally formulated policies, it needs to be accompanied by an effective policy dialogue between donors and partner governments, as well as among donors. This can easily lead to an increased upstream involvement of the donor community in the policy-making process.

Where policy dialogue fails, or where it is very difficult - as in the case of Kenya and Uganda (see section 4.3.2.) - pressure can be exerted by freezing budget support or switching it off. As regards the relationships between the EC and ACP countries, the CPA contains provisions for discussing political issues such as the misappropriation of funds - the withholding of budget support being one of the instruments to be deployed in response to a partner country's policy. The question remains, however, as to how effective such measures can be, given a budget support policy which puts the ownership principle up front. Before such measures are taken, they must be clearly weighed against the risk of potentially losing the partner in the process.

Another factor that makes this process so complex is the donor community itself. Will evident misuse result in a joint assessment and hence in the same conclusions being drawn by all those involved in budget support? The experience so far suggests that very few donors have jumped ship, partly as a consequence of peer pressure to go with the flow. But there is no guarantee that all donors will speak with one voice in all future situations.[29]

5.2. Final comments

So where does this discussion lead us? The principle of budget support makes sense, as its underlying philosophy is aimed at improving national accountability and strengthening democratic institutions. This is a central element of the development strategy expressed in the Cotonou Partnership Agreement, which seeks to strengthen recipient countries' capacities and ownership by means of the 'decentralised management' of assistance.

The Agreement also provides a useful framework for pursuing poverty-focused budget support. The spirit of the CPA has been translated into the EC's policy of result-based monitoring, which takes a locally developed PRSP as the basis for formulating indicators to measure the effects of poverty-oriented budgeting. The Agreement also underlines the importance of the principles of partnership and all-inclusiveness, which - as our discussion has shown - have yet to be fully implemented in the context of budget support. But they are recognised and feature on the EC's policy agenda. The CPA defines principles which the EC can apply to the provision of budget support to other countries as well, notably in Asia, Latin America and the Mediterranean.

Without making any judgement about the merits of budget support (the OECD/DAC evaluation referred to in section 4.2.1. was undertaken for the precise purpose of making recommendations in this respect), we should like to make a number of observations about the relative position of the EC with regard to the conceptualisation and implementation of the budget support mechanism.

The EC is one of the prime movers behind this new aid mechanism in the donor community. It has developed a sophisticated technical approach, in terms of design, monitoring and mechanisms for triggering the release of disbursements. The size of past and present investments in the production of operational guidelines and the development of harmonised indicators in the context of Poverty Assessment Frameworks is testimony to its resolve. The EC has also underlined the importance of PFM throughout its operations as of 2001. As such, it sets standards for other donor agencies that can help to harmonise donor policies and approaches.

Harmonising with other donors in the field remains a tedious exercise, though. In countries where condi-

Notes

29 This reduced freedom to take individual decisions could induce donors who remain critical of budget support to remain on the sidelines instead of joining in with harmonised approaches - a situation which is not necessarily undesirable. The question is whether fully harmonised approaches and decision-making processes are indeed appropriate. Taken to extremes, they could result in an all-or-nothing disbursement decision for budget support - with the risk of destabilising the country in question - or in full disbursement irrespective of the country's performance. There would no longer be any opportunities for individual donors to signal their satisfaction or dissatisfaction.

tions permit a result-based approach to monitoring - which is of vital importance to the EC's approach on budget support - the differences with other donors are not clearly apparent. But where more flexible approaches are required to monitor performance based on process outputs and outcomes, the EC is perceived as being a difficult partner to work with. Attempts have been made to adopt a more flexible stance in the field, but as the EC is closely 'watch-dogged' by the European Court of Auditors, its space to manoeuvre is limited. The same factor also restricts the EC's freedom to ease sometimes excessively strict rules and procedures and to align them with the systems used in partner countries - a regular subject of criticism by partner country representatives.

In terms of the magnitude of budget support, the EC envisages disbursing some 30% of the 9th EDF in the form of general budget support. This is a rather ambitious figure, given the late start of disbursements under the 9th EDF (in 2003) and the fact that large amounts of budget support are earmarked for countries which do not have satisfactory PFM systems and accountability mechanisms in place. However, the sheer amount of the budget support that the EC can mobilise for a partner country is so great that it can direct a partner country's development path towards reform. The strengthened EC delegations have stepped up their roles in this regard in the past few years.

With the move towards budget support, the EC has also restructured its organisation and operations and strengthened its capacities in the field with the aid of a massive deconcentration of staff. Preliminary observations suggest that the results so far have been mixed. While considerable efforts have gone into the strengthening of financial and administrative capacities, programmes in content areas which are supported through (general or sector) budget support - such as health, education, decentralisation or support for civil society - cannot be fully monitored due to the absence of sufficient numbers of qualified staff.

So the EC is at the cutting edge in certain areas, but still has a long way to go before achieving its ambitious goal, namely, making budget support its main aid mechanism. The EC is still testing the practical use of budget support in many countries. The basic picture is that things are moving in the right direction. Budget support can help governments achieve their MDGs, as it can improve the channelling of aid. It has evolved out of various fragmented aid approaches adopted in the past which have not worked. The goal in recent years has therefore been to create a holistic and poverty-oriented development framework for each country, bringing together macro-economic and micro-economic development approaches under the same umbrella, to assemble the myriad of external donors under the leadership of partner country governments, and to improve accountability and governance. Basically, budget support should feed this process with funds so as to get the machinery running. The EC is one of the main funding partners for this process.

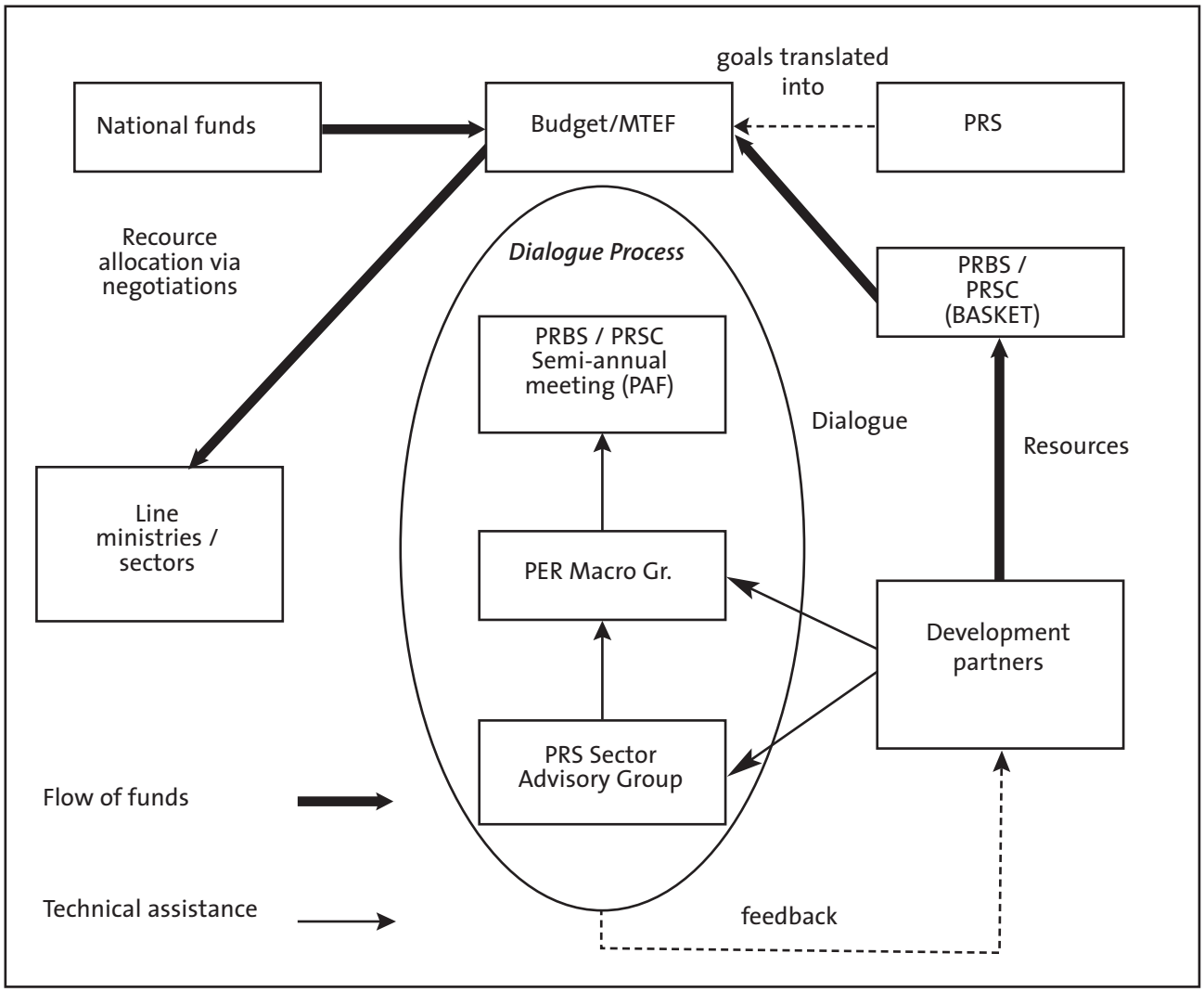
But these assumptions make the process of budget support provision incredibly complex and long-lasting, and endow it with a potential for discouraging the partners involved. It is certainly not a quick and cheap disbursement mechanism. Budget support leans heavily on policy analysis and to a certain extent on planning. Moreover, it can create a control culture with a potentially high political cost of policy conditionality in the partner country. We therefore need to ask whether it is manageable at all. There is also a need for better analysis and understanding, as well as for a constructive dialogue about what this mechanism can and cannot achieve, where it is most appropriate and where other mechanisms are better suited.

This does not mean that the concept should be rejected outright. Polarisation should be avoided. Compared with other types of aid delivery, budget support has its advantages and the risks and problems associated with it should be weighed against the pros and cons of alternative instruments. Moreover, it addresses fundamental problems, such as PFM, which could not be solved in the past. The above concerns are highlighted to indicate that budget support is not a panacea and is not the only solution in all settings in which the EC provides assistance. The EC's strong focus on budget support and sector support needs to be put into perspective, however.[30] Without complementary measures, in particular the removal of trade barriers and the pursuit of an improved international security agenda, a poverty-oriented policy framework and budget support (including support for capacity development) are unlikely to make a substantial difference to a country's development.

Notes

30 See, for example, Report back to Parliament on progress made on commitments given to Parliament, Speech/04/443, 7 October 2004, by Poul Nielson, former European Commissioner for Humanitarian Aid and Development.

Annex 1 - Diagram of a budget support process



An ideal form of budget support would be along the following lines. [31]

- Poverty Reduction Budget Support **(PRBS)** and Poverty Reduction Strategy Credits **(PRSC)** meetings identify pledges by **development partners**.
- Resources flow through the PRBS/PRSC process into the national **budget**.
- The Mid-Term Expenditure Framework **(MTEF)** is the main tool for coordinating and prioritising the objectives formulated in the Poverty Reduction Strategy **(PRS)** and the resources provided. Resources are allocated to line ministries and sectors.
- The PRBS/PRSC semi-annual meeting is the principal place for the government and its development partners to discuss substantial issues of the assistance along the issues featured in the Performance Assessment Framework (PAF).
- The government and its development partners meet in the Poverty Expenditure Review (PER) and Macroeconomic policy dialogue and cooperation group to cooperate technically on the basis of the PRBS/ PRSC process. Technical assistance (TA) supports this process.
- PRS Sector Advisory Groups assist the line ministries to improve their planning and budget process. TA supports this process.

Notes

31 This is a rough outline reflecting the current efforts of the government of Tanzania and its development partners to bring all resources provided through budget support under a single umbrella, guided by a common approach. Adapted from Aarnes (2004).

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