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BUDGET SUPPORT: CONCEPT AND ISSUES

Stefan Koeberle and Zoran Stavreski

The World Bank



The World Bank

Abstract

Budget support has become an increasingly important instrument in the context of a partnership-based approach to development assistance. A growing number of donors and recipient countries are gaining experience with this aid modality that consists of financial assistance provided directly to partner country's budget on a regular basis, using its own financial management systems and budget procedures. Compared to traditional modes of aid delivery, budget support promises greater country ownership, reduced transaction costs, better donor coordination, scaling up of poverty reduction and potentially greater development effectiveness. This paper presents a synopsis of some key concepts, issues and emerging good practice relevant to budget support as an aid modality.

Its objective is to provide an overview of general concepts, suggest the rationale and objectives of budget support and draw together some terminology and definitions. The paper presents principal characteristics of budget support and explores basic differences with other modalities of development assistance in a historical context. It outlines a number of key issues related to budget support that are at the core of ongoing discussions about its effectiveness, including choice of instruments, selectivity, predictability and donor coordination.

To ensure overall best results, each country case requires a specific judgment on the appropriate choice of aid instruments. Budget support is most appropriate for countries with good track record, strong country ownership, stable macroeconomic environment and acceptable fiduciary risk. Budget support is outcome oriented approach. Despite implementation challenges in institutional capacity building, reducing transaction costs, and improving donor coordination, budget support overall emerges as a robust framework for more effective development assistance. To fully realize its benefits and mitigate its risks requires sustained efforts by donors and governments over the medium term.

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BUDGET SUPPORT: CONCEPT AND ISSUES

Draft paper for Cape Town Workshop

1. Introduction: Objectives and Coverage

Budget support has become an increasingly important instrument of development assistance. It has received growing attention by bilateral donors and international financial institutions (IFIs) in the context of a partnership-based approach to development assistance. Donors and recipient countries alike have been gaining experience with this aid modality, which promises greater scope for scaling up development assistance, reduced transaction costs, greater country ownership and potentially greater development effectiveness than traditional modes of aid delivery.

Yet the concept of budget support itself is still emerging and subject to different interpretations. It has also raised skepticism among observers who question the impact, fiduciary soundness and incentives of budget support.

This paper presents a conceptual synopsis of budget support as an aid modality. Its objective is to provide an overview of general concepts, suggest the rationale and objectives of budget support and draw together some terminology and definitions. The paper presents principal characteristics of budget support and explores basic differences with other modalities of development assistance. It outlines a number of key issues related to budget support that are at the core of ongoing discussions about its effectiveness, including selectivity, predictability and choice of instruments.

The remainder of this paper is organized as follows: A brief historical perspective on aid modalities is provided in Section 2. Section 3 provides an overview of definitions for budget support. Section 4 explains key characteristics and explores the rationale for budget support. Section 5 discusses the choice and mix of aid instruments. Section 6 explores key considerations in determining whether the conditions for budget support are appropriate. Section 7 discusses design issues. Section 8 highlights a number of issues that have emerged in implementing budget support. Section 9 summarizes.

2. Aid Modalities: A Brief Historical Perspective

Development assistance is provided in a variety of modalities, including budget support, sector programs, investment projects, and through non-financial support including analytical work and technical assistance. There are numerous instruments within each of these modalities: e.g. poverty reduction support credit and poverty reduction growth facility are major budget support instruments used by IFIs. The choice of instruments and the appropriate mix depends on the partner country needs and priorities, consensus on policies and capacity for implementation, and specific donor objectives and constraints.

The Rise and Decline of the Project Paradigm

For most of the last fifty years, foreign aid was provided through donor-managed projects. This approach was based on the premise that lack of physical investment is the main obstacle to development. In addition, donors generally believed that separate project management and accounting structures of independent projects provide the most appropriate arrangements for mitigating fiduciary risk, irrespective of a country's policy and institutional environment.

Project aid can be defined and distinguished by two characteristics: (i) identification of specific areas of intervention for donor involvement; and (ii) the targeted use of funds for specific activities for which

objectives and the inputs required to achieve them have been defined (Foster and Leavy:2001). Projects can provide technical assistance, training and commodities to solve a few key problems or deliver services, often in a limited geographic region. Results pursued are specific to the project and accountability is limited within the scope of the project, with little if any influence outside the project. The level of local ownership for projects may vary, but typically this form of aid delivery involves a high degree of donor control.

Projects are sometimes, but not always part of the government budget and subject to policy conditions related to the project and the relevant sector, and resources could be disbursed and accounted for using government systems. Even in these cases, additional statements on expenditure eligibility and specific project accounts are often added to standard government financial procedures. However, most project aid makes limited use of government systems. Instead, it typically uses parallel systems, where the donor often takes the lead in design and appraisal, decides the inputs to be provided, and uses its own disbursement and accounting procedures.

However, evaluations of aid effectiveness pointed to a number of well-known shortcomings of traditional project-based assistance:¹

- (i) a high level of involvement and control by donors over the selection, design and implementation of projects, has undermined local *ownership* of the development process;
- (ii) by working outside of regular government systems, in particular budget planning and execution, accounting and procurement, project assistance may miss the opportunity to support *institutional capacity building process*. To the contrary, by establishing parallel management structures, it may in fact undermine the capacity of the governments to design and manage the development process²;
- (iii) different reporting and accounting requirements contribute to excessively high *transaction costs*, in particular in countries with a large number of projects and donors;
- (iv) a multitude of separate projects with different conditions and requirements for disbursement makes the size and timing of *funding less predictable*;
- (v) project assistance promotes external *accountability* of the governments to donors, rather than intra-government accountability (between central ministry and the line ministries) and internal government accountability (to citizens, parliaments, etc.);
- (vi) results pursued by individual projects are *limited and specific to the project*. There is a narrow potential for achieving higher-level impacts that depend on activities beyond the scope of the individual project;
- (vii) financing of multiple independent projects, often with weakly aligned objectives, has contributed to *suboptimal efficiency of spending*.

Not all of these weaknesses are relevant for all projects, and some may be addressed by improved design and implementation. World Bank projects, for example, are often implemented as part of the recipient country budget, are sometimes subject to specific project and sector covenants, and government systems are used for disbursement and accounting of the resources.³ However, fundamental problems of aid

¹ Brinkerhoff, 1991; Bolger 2000; European Commission 2003; Lawson at al. 2002 5-6; Takala and Marope, 2003 16-18; World Bank *Aid Effectiveness Report* 1998.

² The *World Bank Aid Effectiveness Report* (1998) emphasizes the adverse impact on institutional development: "Aid agencies have a long history of trying to "cocoon" their projects using free-standing technical assistance, independent project implementation units and foreign experts – rather than trying to improve institutional environment for service provision...They have neither improved services in the short run nor led to institutional changes in the long run."

³ Still, in some cases additional expenditure statements and project accounts may be required to accompany normal government procedures.

financed projects - working outside of regular government systems that undermines country ownership and leads to higher transaction costs – can typically not be addressed within traditional project arrangements.⁴

Adjustment Lending: Promise and Disillusion

During the 1980s, financial assistance in the form of balance of payments support emerged as a significant—and often controversial—tool to help countries in managing external financing constraint. World Bank adjustment lending was originally conceived as a financing vehicle for short-term balance of payments support. IMF financial support may be provided in this form, when foreign exchange is transferred to the Central Bank and the formal accountability limits to reviewing the macro program, including targets for foreign exchange reserves.

Balance of payments support through policy-based lending is a modality designed to promote economic stability by providing financing for addressing immediate gaps in the country's balance of payments.⁵ The World Bank's adjustment lending in the 1980s was aimed primarily at addressing economic distortions of debt sustainability, trade imbalances, and exchange-rate overvaluations. As countries completed first-generation reforms and liberalized their foreign exchange and trade regimes, the emphasis shifted to medium-term institutional policy actions.

Balance of payments support in the form of adjustment lending involves conditionality on policy reforms and measures agreed to be implemented.

Poverty Reduction and Country Ownership

In the 1990s, the emphasis of development assistance shifted towards supporting countries to overcome their internal, fiscal constraints to help address poverty reduction. At the same time, donors increasingly emphasized country ownership of development programs. Research on aid effectiveness suggests that policy programs can be effective only when they are “owned” by the country itself.⁶

Central to the change was the recognition of the importance of country leadership and ownership of the development process, stronger partnerships among all stakeholders, and a focus on results as a way to measure development impact, including the achievement of targets set out in the Millennium Development Goals (MDGs). Coupled with a growing body of empirical evidence and lessons learned, the increased emphasis on country ownership also helped trigger discussion on, and a change in conditionality, from its traditional role of inducing and leveraging reforms to a means of reaching mutual understanding with governments on reform priorities.

The strong emphasis on poverty reduction and country ownership laid the groundwork for the introduction of the PRSP approach within the framework of enhanced HIPC debt relief initiative. The PRSP has evolved as the donor community's central framework for engagement in low-income

⁴ Moreover, the claim that separate project structures provide more reliable financial management systems, considered to be one of the strongest features of project assistance, was also undermined in the 1980s and 1990s by numerous cases of fraud, corruption and mismanagement of funds.

⁵ In the early years of structural adjustment, disbursements were made against a list of imports, which was abandoned in 1996.

⁶ World Bank, *Adjustment Lending Retrospective* (2001); and World Bank *Annual Review of Development Effectiveness: Making Choices*, Operations Evaluation Department (2002).

countries.⁷ The World Bank introduced Poverty Reduction Support Credits (PRSCs) in 2001 as one of IDA's main vehicles to support low-income countries in implementing their Poverty Reduction Strategy Papers (PRSPs).⁸

The PRSP initiative was seen to embody a “new way of doing business” in low-income countries. The main objective was to assist countries improve the poverty impact of public policy and expenditure by developing and implementing more effective strategies. This process requires adherence to four principles – country ownership, comprehensiveness and long-term perspective, results orientation, and partnership. Governments of low income countries have been expected to take a lead role in setting out its vision and defining the country's policies and programs to reduce poverty, working collaboratively with domestic stakeholders and donor partners to tailor the PRSP to country conditions and circumstances.

The PRSP process has contributed to greater collaboration and harmonization among donors and between donors and partner countries. Particularly in countries where multiple donors are providing budget support, harmonization has become a central aspect of the PRSC. Over the past few years, the political momentum for harmonization and alignment has grown. At the March 2005 High Level Forum on Harmonization in Paris, donors reiterated previous commitments made in Rome and Monterey to coordination and harmonization.⁹ The objective is to enhance aid effectiveness by moving away from the fragmentation, duplication, and the high transaction costs to government that to a large extent still characterizes foreign assistance.

Sector-Wide Approaches (SWAps)

Sector-Wide Approaches (SWAps) emerged in the 1990s as a financing vehicle for major donors to provide support within a specific sector framework coordinated by the government. SWAps are normally funded by donor pooling funds in a “basket” or trust funds that are kept separate from recipient country allocation and accounting systems. Therefore, funding is less flexible compared to budget support, and there is no clear commitment to using and strengthening government systems and institutional capacity.

A SWAp is a program-based approach that operates at the level of entire sector. SWAps are most commonly defined as multi-donor funding for a sector in support of single sector policy and expenditure program, under government leadership, adopting common approaches across the sector, and progressing towards relying on government procedures to disburse and account for all public expenditures, however funded.¹⁰ This definition focuses on the intended direction of change rather than just the current attainment.

However, program-based approaches may also be applied in a wide range of circumstances other than SWAps and at other levels. For example, program support may be on-budget and off-budget, and may or may not be managed using local procedures; it could involve different types of earmarking for a particular sector, or for specific activities within a sector. Program approaches may also involve a number of countries, as happened under the Nile Basin Initiative, or be implemented at sub-national levels of government, for instance at the provincial or state level in large countries.

⁷ See *Poverty Reduction Strategy Papers – Detailed Analysis of Progress in Implementation*, a series of annual reports by the World Bank since 2001.

⁸ *Interim Guidelines for Poverty Reduction Support Credits (PRSC): Discussion Draft*, (IDA/SECM2001-0251), World Bank, April 10, 2001.

⁹ *Paris Declaration on Aid Effectiveness: Ownership, Harmonization, Alignment, Results and Mutual Accountability*, High Level Forum, March 2005.

¹⁰ Foster, M. and A. Fozzard (2000). “Aid and Public Expenditure: A Guide”. Overseas Development Institute Working Paper 141

The SWAp is not an aid instrument, but rather an approach: the structure, coverage and procedures adopted by SWAps may differ within as well as between countries. In practice, SWAps may include variety of instruments, from a set of coordinated projects (which may or may be not earmarked to specific expenditures or disbursed through the standard government's budget process) to sector budget support (see box 2). SWAp donors often pool their funds in a "basket" outside the government's budget. Most recently, donors are exploring arrangements to provide funds that are disbursed through the government's own budget process.

Irrespective of how money is disbursed and accounted for, the defining feature of a SWAp is that donor funding supports a set of sector policy reforms and a single expenditure program. Similar with budget support, the decision whether to engage will require an agreement on the policies and expenditure programs within the sector, assessment of the sector institutional capacity to implement the agreed program, and the quality of financial management system in that particular sector. Progress is assessed through regular jointly reviews.

The context for the emergence of budget support

Recent trends in the international aid architecture have provided the context for an increasing emphasis on budget support as a financing modality to address the need for medium-term commitments:

- *Shift away from traditional project support.* The effectiveness of traditional project financing in many countries continued to be questioned by donors that were concerned over parallel systems outside the government's budget framework, low disbursement rates and limited impact. An increasing number of donors responded to the problems by moving from supporting specific projects to more strategic medium-term assistance, increasingly in the form of budget support.
- *Shift from traditional policy conditionality to partnership-based approach,* reflecting the disillusionment with traditional ex-ante conditionality. The new approach to development assistance emphasized the need to promote modalities such as budget support, which provide more effective structures for strengthening the mutual accountability between donors and recipients, achieving greater predictability of funding and lower transaction costs for recipient countries.
- *Greater emphasis on country ownership, systems and capacity.* The 1990s brought a realization that local ownership and partnership around country owned development programs are prerequisites for the achievement of sustainable results.¹¹ This approach actually recognizes the critical importance and benefits of countrywide and sector-wide perspective, and strong policies and institutions.
- *Shift from short-term to medium-term reforms.* Reflecting the experience and changing needs of recipient countries, development assistance in the 1990s began to give increased attention to support for sustained structural and social policy programs, as well as capacity building and institutional reforms. Although the need for addressing short-term distortions remains appropriate in some cases, most of the policy programs have a medium-term perspective, supporting complex policy and institutional reforms critical to sustainable development.

¹¹ This vision has been articulated in various documents and policy statements, as summarized in the 2003 multi-partner evaluation of the World Bank's Comprehensive Development Framework (World Bank OED, 2003).

- *Recognition of disruptive role of aid volatility and unpredictability of funding.* Poorly delivered and unpredictable aid proved to create long-lasting problems for macroeconomic management in low-developing countries. A study by the OECD (2003) identified “uncoordinated donor practices” and “delays in disbursements” as two of the five most burdensome donor practices. Recognizing the problem, donors called for creation of new aid mechanisms aimed at reducing aid volatility and unpredictability. Development Committee of the World Bank and IMF (2004) called for provision of “predictable and timely financial assistance to countries committed to sound policies.” The U.K. proposed the International Finance Facility (IFF), a plan to increase aid flows with a goal of achieving the Millennium Development Goals, stating that the IFF would provide “for the first time, a predictable and stable flow of a critical mass of aid” (DFID, 2003).
- *Aid effectiveness research suggests greater selectivity in favor of good performers.* Lessons learned indicate that aid financing works in good policy environments, which can absorb large amounts effectively, but does not work in bad policy environments. Budget support is appropriate for countries with strong ownership, commitment, and sufficient capacity to allocate resources effectively and in accordance to their development priorities. However, good track record need to be confirmed over longer time span, as levels of performance count, and not short-term changes. The experience indicates that in particular caution is required in assessing windows of opportunity for “turnaround” cases.
- *Enhanced focus on results.* In the past, policy-based lending and other forms of development assistance were focused on policy actions, and did not always pay appropriate attention to intended outcomes.¹² Building on these lessons, a growing tendency appeared to sharpen the focus on achieving results, with improved monitoring and evaluation of development programs. The Millennium Development Goals adopted in 2000 posed further challenges for strengthening the focus on results.

3. Defining Budget Support

There is a range of definitions for budget support applied by various donor organizations. In current usage, budget support typically refers to predictable, annual, medium-term resource flows, based on progress in achieving the objectives of the government’s PRSP. For the purpose of this paper, budget support is defined as a form of financial assistance provided directly to a partner country’s budget on a regular basis, using its own financial management systems and budget procedures (box 1).

The aid provided as budget support is linked to sector or national policies rather than specific project activities or budget line items. This reflects the potential of budget support to address key cross cutting issues such as public sector reform, public financial management or improvements in governance. Budget support typically aims to promote pro-poor growth through encouraging fiscal and macroeconomic stability and more efficient allocation of public funds.

While multilateral donors have long used policy-based lending, budget support has only been used in recent years to support country programs, commonly in support of the multi-sector priorities of PRSPs. Particularly in the context of aid-dependent African countries budget support involves alignment with the PRSP’s annual cycle of performance review and with domestic planning and budget processes.

¹² See for instance World Bank *Adjustment Lending Retrospective*, 2001 and World Bank *2003 Annual Review of Development Effectiveness*, Operations Evaluation Department.

Box 1. Definitions

Policy-based lending: Provision of untied donor resources directly through the government's budget, using the government's own financial management, procurement, auditing, and implementation processes and systems, and based on a set of policy or institutional reforms fulfilled either ex ante (conditionality) if designed as a multi-tranche, or ex post (prior actions), if designed as a single-tranche, operation.

Development policy lending (DPL): The Bank term for policy-based lending; replaced *adjustment lending* as the Bank's financing instrument to provide quick-disbursing resources to client governments.

Poverty reduction support credit (PRSC): A programmatic approach to DPL in low-income countries that is tied to the country's medium-term PRSP and typically consists of a series of three or four single-tranche operations.

Budget support: Donor instruments (including the PRSC) that are tied to the country's medium-term PRSP and consist of annual disbursements of untied resources to the budget. Budget support is typically based on an agreed set of performance indicators in the form of institutional or policy reform measures or outcome indicators.

Program-based approaches (PBA): A general term that refers to coordinated donor support to implement a comprehensive program (e.g., PRSP) or a specific sector/thematic strategy (education, environment) that is country-derived and relies on a single budget framework and domestic processes. PBAs include budget support and SWAs.

Sector wide approach (SWAp): An approach that involves financing of a specific sector through various financing modalities, including budget support and investment financing.

The World Bank only recently formally recognized the notion budget support with the introduction of Development Policy Lending, although it has been used informally for a number of years. Typically, budget support in the World Bank context is best characterized by the Poverty Reduction Support Credits (PRSCs), which are typically provided to better performing PRSP countries.¹³

Donor Definitions

Bilateral donors have their own array of definitions, aligned around the premise that budget support is a sub-set of program aid (program-based approaches):

- The OECD definition outlined in recent DAC guidelines defines budget support “as a method of financing a partner's country budget through a transfer of resources from an external financing agency to the partner government's national treasury. The funds thus transferred are managed in accordance with the recipient's budgetary procedures.”¹⁴
- CIDA (2003) defines budget support as “program support that is provided directly to host-country institutions to be spent as part of their budgets using their own financial management systems.”
- DFID Policy Paper (May 2004) speaks about *Poverty Reduction Budget Support (PRBS)* as a form of financial aid in which funds are provided: (i) in support of a government program typically focusing on growth, poverty reduction, fiscal adjustment and strengthening institutions, especially budgetary processes; and (ii) directly to a partner government's central exchequer, to spend using its own financial management, procurement and accountability systems.

¹³ World Bank (2005) *A Stocktaking of Poverty Reduction Support Credits*. Operations Policy and Country Services. May 2005.

¹⁴ DAC Guidelines and Reference Series, *Harmonizing Donor Practice for Effective Aid Delivery: Volume 2; Budget Support, Sector-Wide Approaches and Capacity Development in Public Financial Management*, OECD, 2005.

Box 2. Sector Budget Support

Several bilateral donors make a distinction between two types of non-project aid that they refer to as *direct budget support*:

- *General Budget Support* defined as a general contribution to the overall budget, (sometimes referred to as *macro support*); or
- *Sector Budget Support* defined as financial aid earmarked to a discrete sector (with any conditionality relating to these sectors).

Under this definition, sector budget support is usually related to a broad area, such as education and health, or a sub-sector, such as primary health-care financing. The focus of the dialogue is not on the overall budget priorities, but on sector-specific concerns. Sector program assistance supports the implementation of reforms and other actions needed to overcome sector based development constraints. Additional sector reporting may supplement standard government accounting, although the disbursement is usually based upon government procedures.

To some extent, sector budget support could be considered as an intermediary category between budget support and SWAs, as it combines use of government systems with real earmarking of funds to specific sector(s). (However, some forms of SWAs can also fall into this category). The use of “real” earmarking is one of the features distinguishing sector budget support from general budget support.

- *Real* earmarking relates to situations where spending on agreed budget lines need to precede the release of tranches.
- *Virtual* earmarking is used where the control over the use of provided funds is exercised *ex post*. Funds are provided to the budget and the use of resources is then justified against agreed budget lines.

Most of the expectations of this aid modality and the key implementation issues relate to general budget support that is not earmarked and made freely available to recipient countries. By contrast, financial aid that is earmarked to a specific sector can be an effective tool to reflect donor preferences, but does not capture the essential features and promises of a general contribution to the budget. It is this broader definition of budget support without earmarking that will be referred to in this paper.

4. Budget Support: Characteristics and Rationale

Key characteristics of budget support include the following elements:

- (i) *channeling of donor funds to a partner country using its own allocation, procurement and accounting systems;*
- (ii) *funds support a recipient country's own development programs, typically focusing on growth, poverty reduction, fiscal adjustment and strengthening institutions, in particular budgetary processes;*
- (iii) *the policy content and performance assessment and accountability framework of budget support is focused on policy measures and benchmarks related to overall budget and policy priorities, as set out in the country's own strategy (PRSP) and medium-term expenditure framework (MTEF);*
- (iv) *donor funding is provided at regular intervals, ideally in alignment with the country's annual budget cycle.*
- (v) *with agreement on the general budget priorities and expenditures, in principle there is no need for earmarking of funds for specific budget expenditures.*

While balance of payment support attention is on the foreign exchange, budget support focuses on the local currency counterpart to the foreign exchange. However, in both cases domestic currency

government deposits at the Central bank as a counterpart to foreign exchange will increase. In principle these deposits are available for withdrawal by the government. Funds could be used for reducing borrowing or repayment of debts, but also for increasing budget spending. The balance between these choices depends on the overall macroeconomic and fiscal situation, and the agreement on development priorities between the partner country and the donor.

Accountability is based on audited accounts on budget revenues and expenditures, although some donors may ask for accounting against specific budget expenditures. However, if there are weaknesses in public financial management, additional fiduciary arrangements and accountability mechanisms may be warranted in order to address these issues. Funds can be accounted to certain sectors, but there is no formal limitation on where they may actually be spent.

Expectations. Underlying the shift to increased budget support by many donors were a number of expectations:

- better prospects for strengthening country ownership
- reducing transaction costs
- ensuring sustainability of reforms
- increased predictability of funding
- addressing government-wide issues that can not be tackled with stand-alone and sector projects
- promoting accountability
- improving the efficiency of budget spending
- encouraging greater results orientation
- focusing on national priorities rather than on operational issues or activities with limited scope and effect

Concerns. However, there are also number of issues and concerns related to budget support:

- greater fiduciary risk in countries with weak financial management systems
- increased volatility of aid flows in case when country performance is poor
- increased transaction costs on short-term in some cases
- less incentives for line ministries to work on the conditions for release of funds
- straining of the capacity of the Ministry of Finance as main interlocutor, etc.

An assessment of whether potential benefits of budget support have materialized and risks have been successfully mitigated, requires more thorough analysis of the experiences to date. A number of recent and ongoing evaluations of budget support are highly relevant and timely in this respect (see box 3). While it may be too early to formulate conclusions, the following sections will present a number of key issues and emerging lessons on budget support.

Box 3. Recent and ongoing Evaluations of Budget Support

- *OECD “Harmonizing Donor Practices for Effective Aid Delivery, Volume 2: Budget Support, Sector-wide Approaches and Capacity Development in Public Financial Management”*. This paper focuses specifically on good practices in providing budget support and support to SWAs. It particularly acknowledges the special relevance of public financial management issues for both of these modalities of aid delivery;
- *EC “Budget Support: An Innovative Approach to Conditionality”*. This paper deals essentially with general budget support in ACP (Africa, Caribbean and Pacific) countries. It provides the rationale and mechanism of EC approach to budget support based on annual fixed and variable tranches. It also analyzes the experience to date, including issues of scope, program design and implementation.
- *DFID “Evaluation Framework of General Budget Support” commissioned on behalf of the OECD-DAC Evaluation Network*. This report presents an Evaluation Framework intended to guide the conduct of joint evaluation work on General Budget Support (GBS) at the country level. It is intended as a practical tool that can be used to assess whether GBS is relevant, efficient, effective and sustainable mechanism for poverty reduction. The Framework is based on a flow of diagram of the Logical Framework type, which spells out the casual linkages posited by the implicit thinking behind recent GBS programs;
- *World Bank (2005). “A Stocktaking of Poverty Reduction Support Credits”*. This paper takes stock of the Bank’s experience with the PRSC and highlights lessons learned, key issues, emerging practices, and recommendations. With very few countries having completed their first series of PRSC operations, the general thrust of the paper is on design and implementation issues. The paper does not attempt to assess development impact, although it highlights preliminary medium-term outcomes from the more mature PRSC programs;
- *Strategic Partnership for Africa – Budget Support Working Group (2005). Survey of the Alignment of Budget Support and Balance of Payments Support with National PRS Processes*. The primary objective of this report is to describe the current status of efforts to align the delivery of budget support and balance-of-payments support with national policy-making processes, budget cycles and systems for reviewing progress. Secondary objectives are to promote policy dialogue on this subject, disseminate good practices and identify countries where follow-up activities by the SPA might bring benefits;
- *ODI (2004). “Joint Evaluation of General Budget Support Tanzania 1995-2004 Phase 2”*. This is report to the Government of Tanzania and to the Poverty Reduction Budget Support (PRBS) Development Partners. It is a preliminary assessment of efficiency & effectiveness of Budget Support and recommendations for improvement;
- *USAID (2004). “General Budget Support to Tanzania: A Snapshot of Its Effectiveness”;* *“General Budget Support: An Alternative Assistance Approach Mozambique Country Case Study”;* and *“General Budget Support and Sector Program Assistance: Malawi Country Case Study”*. These brief papers represent an effort to capture the effectiveness of general budget support as an aid instrument. They are part of the Evaluation Office’s field efforts to analyze conditions needed for successful general budget support.

5. Choice of Instruments

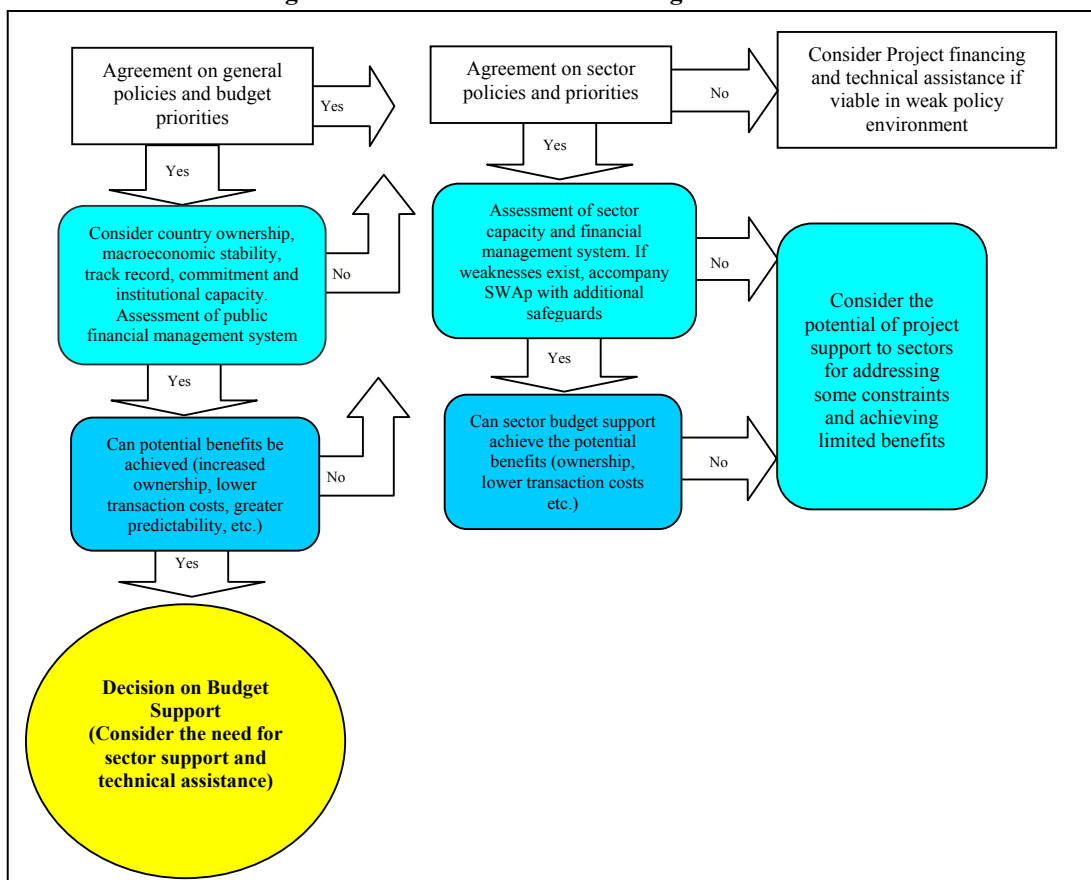
Budget support is not necessarily the right approach for all countries at all times. It is rather only one of various modalities for providing development assistance that can play different roles under varying country circumstances. To ensure overall best results, each country case requires a specific judgment on the appropriate choice of instruments by donors and partner countries. While there may not be a uniquely appropriate mix of instruments, a considered judgment typically involves a variety of factors, including the degree of consensus on policies and budget priorities, and the institutional capacity of the recipient

country to implement the policy program and account for effective use of resources. Appropriate phasing of the various lending modalities is also important. Country realities often call for an incremental approach that emphasizes capacity development, trust building and progressive adoption of new mechanisms such as budget support, as noted by Pavignani (2001).

When is budget support most appropriate? The emerging consensus among donors is that budget support provides a more effective approach to development assistance for countries that have a good track record and a reasonably sound policy and institutional framework, including transparent budget and adequate financial management arrangements. For these countries, it may be appropriate for budget support to be the main aid instrument—which can be accompanied by complementary technical assistance and project financing, as needed.

Instrument choices typically involve the types of issues highlighted in a decision tree along the lines of Figure 1. A first consideration is if there is an agreement between donors and the partner country on policies and budget priorities on a country level.¹⁵ In cases where the policy dialogue can result in agreement on these issues, other preconditions for the effectiveness of budget support need to be considered: strong ownership, macroeconomic stability, good track record, and commitment and capacity to implement reforms. Emerging good practice emphasizes these factors as critical for achieving the potential benefits of budget support in terms of predictability, transaction costs, and institutional capacity building.

Figure 1: Decision Tree for Choosing Aid Instruments



¹⁵ Within budget support arrangements, donors may also be involved in policy dialogue and technical assistance at the sector level, with or without accompanying financial assistance. If financial support to a sector is provided, it should be part of an overall government budget.

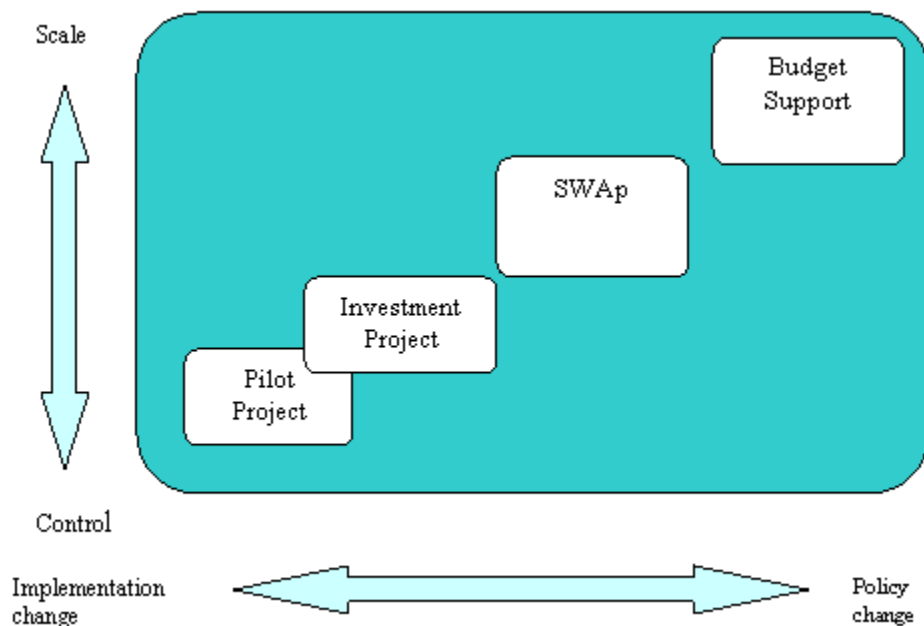
The decision-making process also includes careful assessment of risks. Such risks include, for example, the adverse impact for recipient countries of fiscal adjustments if budget support is suddenly reduced in case of inadequate performance. For donors, the risks include fiduciary and political concerns.

In countries with weak public financial management systems, additional safeguard measures may need to accompany budget support. These could be in a form of conditionality, earmarking or additional accountability requirements. Support may be linked to technical assistance to overcome specific weaknesses in fiduciary arrangements. At the same time, there are country situations where budget support cannot be considered as an appropriate approach, particularly when potential benefits are outweighed by perceived risks.

Budget support may not be appropriate if there is no adequate public financial management system in place, the country has not developed a viable poverty reduction strategy, or donors cannot find sufficient common ground with a recipient country’s general policies and budget priorities. In this case, financial support at a sector level could be considered through a sector wide approach (SWAp) or stand-alone projects. This approach may help build appropriate implementation arrangements that can establish a track record of reform and a growing degree of confidence to facilitate an eventual transition to general budget support.

However, both SWAps and investment projects require a clear agreement on sector policies and priorities. Without a clear sector strategy, such an engagement bears higher risks, which need to be carefully assessed. To justify the risks of engagement, the likelihood of achieving sustainable and significant benefits would have to be considerably higher in this case. Technical assistance or projects may be used in part to contribute to more effective sector policies. Similarly, any decision whether to provide SWAps will require careful assessment of the sector institutional capacity to design and implement the reform program and to account for effective use of resources.

Figure 2: Spectrum of Instruments¹⁶



¹⁶ Developed from Alain Locussol and Ato Brown “Getting Results: The Water Sector and PRSC in Uganda” Presentation.

Where a policy consensus between donors and recipient government cannot be achieved at reasonable costs or within a realistic time frame, traditional projects may continue to have an important role.¹⁷ If the problem reflects a profound difference of opinion between government and donors, technical assistance, analytical work or limited pilot projects may be helpful in establishing a common ground and creating demonstration effects. A possible advantage of traditional projects in the context of a weak policy environment and lack of consensus on priorities is the provision of reasonable returns by allowing for increased oversight of donors in project implementation. However, where country conditions are adequate, budget support is probably more suitable than individual projects for scaling up and achieving policy changes, while focusing less on detailed implementation issues.

6. Key Considerations in Choosing Budget Support

Key considerations in determining whether the conditions for budget support are appropriate include country ownership and accountability, the mix of instruments, selectivity and preconditions, macroeconomic issues, and fiduciary risk.

Country ownership and accountability

It has been widely recognized that sustainable policy reforms must have deep and broad country ownership.¹⁸ The issue of ownership is of central importance, as sustained policy implementation ultimately depends on the existence of strong political commitment. In countries where such commitment does not exist, budget support would not be able to leverage policy actions and effectively steer the reform process.¹⁹

Compared to other aid modalities, budget support creates a framework that tends to be more conducive to strengthening country ownership, for a number of reasons:

- *Integration of external assistance into the national budget.* A shift to more aid provided through budget support increases the overall share of funds that are included in a national budget process. This should also enable better alignment of donor funds with partner country development objectives, as there is no excessive interference of donors in identifying and selecting the priorities. When more support is provided directly in the budget, donors are less prone to micromanage individual programs. At the same time, donors are more likely to engage recipient governments in a policy dialogue on the overall budget process²⁰;
- *Budget support is expected to lead to better management of public expenditures,* as a centerpiece of budget support programs. It brings more flexibility in the execution of the budget, as government can use the funds for financing both recurrent and capital expenditures.
- *Reinforcing accountability relationships within recipient governments.* Budget support has the potential for strengthening intra-governmental accountability by providing an incentive for line ministries to work together with the Ministry of Finance to determine priorities and budget allocations, instead of competing for donor funding. Rather than being accountable to individual

¹⁷ For example, the Strategic Framework for Investment in Africa (SFIA) notes: “IDA remains committed to traditional interventions where they are most appropriate”.

¹⁸ World Bank (1998) *Assessing Aid*.

¹⁹ Country ownership is an elusive concept that is difficult to assess. A number of indicators could be used for assessing government commitment and ownership: the extent of national policy debate; the track record in confronting difficult policy choices; the degree of endorsement by the central and line ministries, civil society, parliaments, etc. One of the more robust indicators for ownership and reform readiness is a country’s track record. See World Bank (2001) *Adjustment Lending Retrospective*.

²⁰ Provision of budget support may allow donors to influence discussion of certain issues over which they might have had little if any influence without providing budget support. However, this is not per se a negative feature

donors that are funding their projects, line ministries are accountable to their Ministries of Finance. On the other hand, budget support arrangements could also weaken the incentives of line ministries to work towards the overall program results expected for the release of funds, since this is considered to be the responsibility of the Ministry of Finance rather than the sector ministries.

- *Budget support provides more discipline in the budget process* by limiting the access of line ministries and other government to extra-budgetary financing. It also can be expected to strengthen their capacity to design and implement programs and poverty reduction strategies.²¹

Strengthening of local ownership could be further supported by donors and recipient governments by (i) focusing on national development policies and priorities, rather than donor priorities; (ii) encouraging a broad national debate and ensuring that the program of policy actions has the endorsement of a broad spectrum of stakeholders or acquiescence of vested interests; (iii) targeting conditionality to reflect development priorities identified in the PRSP and MTEF; and (iii) avoiding restrictions on the use of the funds once the country has met the agreed conditions.

Selectivity and Preconditions

The literature on aid effectiveness stresses the importance of a good policy environment for effective aid.²² This reflects the lessons learned that budget support is most appropriate for countries with a good track record, strong ownership of the reform program, a reasonably sound policy and institutional framework, and commitment and sufficient capacity to allocate resources effectively and in accordance with development priorities.

Donor decisions to provide budget support should generally be based on a positive assessment that a number of critical preconditions for its effectiveness are in place, including:

- an agreement with the recipient country on policies and budget priorities;
- demonstrated commitment and capacity to implement a viable medium-term reform program;
- a clear strategy for prioritization of pro-poor expenditures;
- a transparent budget; and
- commitment to strengthen the adequacy of the public financial management system

Most major budget support donors have implicitly or explicitly or implicitly considered such criteria in making their decisions.

- The World Bank is typically selective in providing budget support. PRSCs have typically been provided to better performers. According to a recent stocktaking of PRSCs²³, this is evident in the relatively high rankings of PRSC countries in country performance ratings based on the Country Policy and Institutional Assessment (CPIA).²⁴ With one exception, every PRSC country falls in the top three quintiles of this rating, with most falling in the top two. This trend appears to be robust. All

²¹ Support for local ownership in this context is not just a matter of enabling control over the reform agenda for the recipient country. It implies commitment that is shared among a broad number of participants, including civil society, parliaments etc.

²² *Assessing Aid*, World Bank, 1998

²³ World Bank (2005) *A Stocktaking of Poverty Reduction Support Credits*. Operations Policy and Country Services. May 2005.

²⁴ The CPIA is an aggregate of performance ratings on public sector management, economic management, and social and economic policies. The CPIA ratings for the year prior to the calendar year of PRSC approval were used (e.g. for projects approved in CY 2004, scores for CPIA 2003) since the ratings are usually finalized by end of the year and become the operational ratings for the next calendar year.

countries that are currently in the pipeline for new PRSCs in the next two fiscal years are ranked in the top three quintiles, with eighty percent of them ranked in the top two.

- The Strategic Framework for IDA's Assistance to Africa reinforces this focus on selectivity, suggesting that larger resource flows could be provided to support programs through national budget and planning processes, if they had improved capacity and a strong track record.²⁵
- The EC approach under the Cotonou Partnership Agreement²⁶ involves granting direct budgetary assistance in support of macro-economic or sectoral reforms if: (a) public expenditure management is sufficiently transparent, accountable and effective; (b) well defined macro-economic or sectoral policies established by the country itself and agreed to by its main donors are in place; and (c) public procurement is open and transparent.
- In the case of DFID, an agreement over the policy framework, revenue and expenditure priorities and a track record of government implementing its stated policies, are considered as essential preconditions for engagement. Eligibility is then based on the government's planned budget priorities to support poverty reduction; its commitment to making administrative, technical, and financial systems robust and reliable; and the relative benefits of budget support vis-à-vis other financing instruments.²⁷

Macroeconomic issues

The macroeconomic situation is an important consideration in determining the suitability of budget support. A stable macroeconomic environment provides a solid framework for efficient use of resources and helps maximize the effectiveness of budget support. Donors' financing decisions typically consider the adequacy of the country's macroeconomic policy framework.²⁸

Budget support is provided in foreign exchange, which is placed with the central bank for converting into local currency and crediting to the central government account at the Central bank. The volume and timing of the transactions involved do not only impact on the volume and timing of foreign aid to a partner country, but also on the predictability of budgetary resources and the relative cost of funding budget deficits. In addition, these transactions may have monetary and foreign exchange rate implications, depending on the timing of conversion and on the potential use of monetary policy instruments for sterilization of the liquidity effects.

Fiduciary risk

Addressing fiduciary risk is critical to effectiveness of budget support. This reflects the nature of budget support as a modality in which donors have little if any influence on individual spending categories once resources are transferred. With budget support, funds are in principle not earmarked, or in some cases there is only virtual (nominal) earmarking. For these reasons, a thorough ex-ante assessment of the government's capacity to use resources effectively is of critical importance.

²⁵ World Bank *Strategic Framework for IDA's Assistance to Africa*, July 2003

²⁶ Cotonou Partnership Agreement. Art. 60 Scope of financing; Art. 61 Nature of financing; Art. 66 Support for debt relief; Art. 67, Structural adjustment;

²⁷ DFID, *Poverty Reduction Budget Support*, DFID Policy Paper, May 2004

²⁸ Bilateral donors often based their assessment on the status of the recipient country's PRGF arrangement with the IMF.

Low-income countries with the greatest need for budget support also often have inadequate financial management systems. They often suffer from serious weaknesses in budget formulation and execution, financial reporting, procurement and oversight systems. There is also typically a weak linkage between agreed policies, budget planning and execution. Provision of budget support in these countries raises legitimate fiduciary concerns that scarce aid resources may be misappropriated or wasted. At the same time, budget support has been used effectively even in fragile countries with extremely weak fiduciary systems—such as Timor Leste and Afghanistan—where clear expenditure priorities and a strong government commitment for addressing institutional weaknesses reduced the risk to an acceptable level relative to expected benefits.

Budget support should help strengthen partner countries' public financial management systems, including transparency and accountability. Improvements in this area are both a precondition for, and objective of this aid modality. However, experience shows that further efforts are needed for achieving sustainable progress. One of the complicating factors is use of different assessment tools by various donors, which implies a risk of divergent and uncoordinated policy actions. In order to strengthen recipient and donor ability to diagnose the public expenditure, procurement and financial accountability systems, to develop capacity-building actions and to standardize the assessment tools, the World Bank and the EC introduced the Public Expenditure and Financial Accountability (PEFA) program in 2001.²⁹

Adequate risk management and mitigation measures could diminish fiduciary risk to some extent. Donors and governments have sought to address weaknesses in the financial management mainly by focusing on institutional approaches and actions for treating fiduciary risks. These include, but are not limited to: (i) enhancing the ability of the governments to track public expenditures; (ii) strengthening of internal and external audit mechanisms; (iii) support for capacity building; (iv) additional safeguard measures; (v) clear agreement on actions to be taken in a case of non-performance. The main challenges appear to be the implementation and enforcement of measures and regulation in the area of public financial management.

7. Key Design Issues

Key issues in designing budget support programs include the tensions between predictability and performance, outcome orientation and institutional capacity.

Predictability, performance and moral hazard

Achieving greater predictability of funding is one of the key objectives when considering budget support.³⁰ Volatility of resource flows has become a potential concern in countries where overall performance is less than adequate—particularly in highly aid dependent countries. Partner countries should have clear, reliable and timely information on the estimated amount, the timing of disbursements and conditions for release of funds. Predictability also implies synchronization of disbursements with the government's budget cycle, in the sense that resource flows should be timed as much as possible to when the government needs them most, typically at the beginning of the fiscal year. This would enable the recipient government to incorporate the funds in the early stage of the budget process and contribute to timely involvement of line ministries in the internal policy dialogue on the priorities and budget

²⁹ In meantime the initiative evolved into partnership between the World Bank, the EC, the IMF, the UK, France, Switzerland, Norway and the Strategic Partnership with Africa (SPA).

³⁰ The multi-partner evaluation of CDF recommends that donors provide “predictable and reliable financing with transparent, multi-year financing indicators, based on clear country performance criteria” (World Bank OED, 2003:xviii).

allocations. Predictability will also enable more efficient strategic planning and ensure adequate links between development priorities and budget expenditures, as set out in the MTEF.

Predictability of flows in the case of budget support is even more important than in other aid modalities, since the funds provided may finance recurrent budget expenditures. It is particularly critical for aid-dependent countries where budget support comprises a large portion of total donor resources. Eventual unexpected shortfalls in these countries will require ad-hoc mid-year adjustments, making cash-flow more difficult and budget process less credible. Ultimately, it could undermine the achievement of poverty reduction objectives.

By providing medium-term assistance based on agreement on policies and budget priorities, budget support could potentially contribute to improved predictability of flow of donor funds. However, since budget support is a more flexible form of financial assistance, the disbursement process may also be more prone to volatility: funds can easily be held up in a case of changing circumstances, or quickly withdrawn in case of non-performance.

The legitimate request for greater predictability of donor funding should be considered only in the context of a partnership-based approach to provide accountability for country performance. When this clear tension between the predictability of aid flows and policy environment is not clearly recognized, there is of moral hazard as budget support is viewed as an entitlement irrespective of country performance or financing needs. It would confirm the findings of Bräutigam (2000) and Moore (2000) that, high levels of aid are dampening the incentives for the government to further develop its own revenue sources. They also claim that this reduces the incentives for the state to remain accountable to its citizens.

The experience shows a variety of cases. The World Bank's approach to make an overall assessment based on triggers allows for flexibility in modulating an appropriate response to variable performance. Responses can consist of a combination of variations in the amount, recalibration of the program or delay of the operation, but are subject to Bank discretion. Some donors have promoted a more rules-based approach that aims for greater predictability and less subjectivity, with a fixed tranche based on a minimum level of conditionality (e.g., continued macroeconomic stability, improved monitoring and evaluation systems) and a variable, performance-oriented tranche that is linked to specific actions or indicators. Different design options have emerged, including outcome-based conditionality favored by the European Commission for their budget support.

In some countries the volatility of commitments and disbursements with budget support seems to be greater than with other aid modalities. There may be several reasons for this, both on the side of donors and recipient countries: complicated internal donor procedures, non-alignment of donor budget cycle with recipient country budget cycle, obscure disbursement conditions, complex fiduciary requirements, politically motivated commitments, a weakly aligned budget process with the PRSP, poorly defined policy reforms, etc.

To some extent the typical alignment problems could be addressed through the introduction of common Performance Assessment Frameworks (PAF) that set out performance benchmarks and targets against which donors make their commitments and that trigger disbursements. However, there may still be a reduced predictability of donor funding when individual donors reserve the right to disburse against their own assessment of progress while others are trying to reach a consensus on the partner government's progress on PAF actions during the annual review. Donor harmonization may reinforce a tendency for common donor positions that could lead to disruptions in resource flows.

Greater clarity and predictability of funding presents significant challenges. Donors and partner governments have a joint responsibility for providing predictable resources. On the side of donors, this

effort usually requires: (a) advance multi-annual commitments; (b) disbursement of funds at the earliest possible stage of the partner country's budget process and fiscal year; (c) better donor coordination and exchange of information about likely timing and conditions of disbursement and (d) an attempt to limit in-year suspension of committed funds only to exceptional circumstances. Ideally, poor performance in the current fiscal year would lead to a reduction in budget support only during the subsequent fiscal year, which would maintain a sufficient degree of predictability.³¹

Partner countries could also contribute to greater predictability of funding by better alignment of their budget priorities with the medium-term policy program and PRSP objectives, preparing contingent spending plans that will indicate how additional resources would be spent or shortfalls adjusted, and by disciplined implementation of agreed policy actions.

Outcome orientation

Budget support is a *results-based approach*. Its effectiveness needs to be measured in terms of budget outputs (more predictable budget financing, increased efficiency of public spending, stronger budget process, strengthened intra-government relations and accountability), and outcomes (enhanced capacity for poverty reduction, environment conducive to private sector development and growth, better delivery of public services) relative to government policy objectives.

While the importance of a result-based approach has been generally accepted by donors and governments, its implementation faces serious challenges. Lack of adequate data and practical difficulties in measuring outcomes pose tensions between governments and donors, but also among donors themselves. Some donors advocate a formal outcome-based approach to calibrate disbursements.³² At the same time, governments are often wary of using outcome and impact targets as conditions of and triggers for credits, particularly when they are held accountable for outcomes outside their control. Areas that are concerned with institutional changes (such as governance and public financial management), however, are less amenable to quantifiable outcome indicators than to process indicators. In some cases, particularly where outcomes and impact are less affected by exogenous factors, results chains are clear, and indicators are available, it might be possible to move to a greater reliance on outcome and impact indicators as conditions and triggers.

Institutional capacity³³

Capacity problems are typical for aid-dependent countries that are candidates for budget support. The experience in the past two decades has underlined the importance of institutional development and capacity building for ensuring sustainability of policy reforms in these countries.

Budget support arrangements and in particular the institutionalized policy dialogue between recipient countries and donors provide an opportunity for identifying major bottlenecks and designing measures for reducing capacity constraints. Budget support relies upon existing recipient capacity, which is strengthened when resources are managed more effectively. By using a country own procedures and addressing cross-cutting governance issues, budget support may improve the effectiveness of the

³¹ Perhaps as a result of these measures, World Bank found that in recent years, budget support to Tanzania is more predictable and less variable than project aid ("Tanzania PER", Report No.26807, 2003)

³² The EC disbursement model specifies that a portion of the budget support is disbursed against an overall assessment and another portion against progress on a set of specific indicators. See European Commission (2005): *EC Budget Support: An Innovative Approach to Conditionality*.

³³ Institutional capacity in this paper encompasses institutional framework (laws, regulation, policies), professional knowledge of government employees and organizational structure of the relevant institutions

government systems as a whole, rather than simply strengthening the capacity inside a project area or sub-sector. Increased aid-delivery through budget support and reduced off-budget project financing creates incentives for line ministries to comply with budget procedures and directives, contributing to a more structured approach to policy development.

However, none of these benefits can be taken for granted, or comes without accompanying risks. The limits to the ability of government systems to shoulder numerous responsibilities delegated from projects should not be underestimated. Increased use of budget support implies more reform efforts to become responsibility of the Ministry of Finance, which further strains its capacity. Donor capacity can also be an issue, as budget support requires different analytical and other skills compared to project financing. Budget support provides a solid framework for building institutional capacity, but the process requires sustained medium-term efforts by donors and governments.

8. Key Implementation Issues

Key issues in implementing budget support include the policy dialogue between donors and aid recipients, transaction costs and donor coordination.

Policy dialogue & conditionality

The shift to budget support has major implications in the way donors engage in the policy dialogue with partner countries. There are two features that distinguish the relationship between donors and partner country in budget support arrangement:

- development partners are more focused on *ex-ante* issues, most notably discussing budget priorities, sector allocations and balance between major budget categories, and less concerned with *ex-post* control on the use of funds; and
- the policy dialogue is focused on national budget priorities, rather than on specific expenditures and procedures. This approach actually recognizes that with fungible financial assistance, the policy dialogue is more effective if concentrated on programs and allocations of budget resources to priority sectors for poverty reduction, such as education, health, agriculture, water, roads etc.

Budget support brings a new dimension to the partnership-based approach, by shifting the emphasis from traditional conditionality to a more long-term mutual accountability framework. Drawing on the lessons learned during the past two decades, there is an emerging consensus that conditionality has become somewhat of a misnomer. Budget support has supported the notion of a partnership with a mutual commitment to support medium-term policy and institutional changes, in which the country decides and implements its own reform agenda set out in their poverty reduction strategies; donors advise on and support good policy reform agendas – with associated frameworks for measuring results – as appropriate with policy based loans and grants. These must be based on a few critical measures that embody real ownership and that will produce better results, rather than on an exhaustive list of conditions. While significant challenges remain, the evidence to date shows encouraging progress in embedding this approach to conditionality in recent policy-based operations.³⁴

The opportunity for an open dialogue on broad policy reforms and general budget priorities is generally considered by many donors as one of the most important elements of budget support arrangements. It is of particular importance for smaller bilateral donors, as an opportunity to contribute effectively to the dialogue on government policies. The policy dialogue between donors and partner country has to be informed by well targeted analytical work, and discuss in a constructive and frank manner what budget

³⁴ *Review of World Bank Conditionality: Issues Note*, World Bank, January 2005.

support can and can not achieve. The changing relationship and increased focus on policy dialogue is reflected in recent organizational and strategic changes, including a greater in-country presence by many donors.

Another important area is the quality of the dialogue. Due to capacity constraints both on the side of partner countries and donors, procedural issues sometimes tend to prevail over policy issues at the expense of the depth of the dialogue. Enhancing the quality of the dialogue and engaging in relevant policy issues in adequate depth requires substantial investment in analytic work, continuous engagement, and adequate skills by donors and government senior policy-makers. It also suggests a clear division of labor among donors in line with their comparative advantage and sectoral expertise. Efforts for capacity strengthening and better understanding of the complexities of budget support as an aid modality may also be more effective when they include oversight institutions, such as parliaments and civil organizations.

Transaction costs

Reduction of transaction costs is one of the key objectives of increased provision of development assistance as budget support. This argument for budget support is related to the use of established government systems for disbursement of resources and monitoring progress, instead of developing multiple reporting and accounting systems for individual projects. Compared to other aid modalities, the expectation is that budget support reduces the need for separate audits, project management or implementation planning. Moreover, there should be improvements in donor coordination and harmonization associated with budget support.

However, experience shows that costs are likely to be reduced only over the medium term, as the various processes associated with provision of budget support gradually improve. In the short term, costs could even be higher, due to the start-up costs and coordination requirements in establishing new modes of interaction between governments and donors. The type of policy dialogue supporting effective budget support requires specific skills and inputs at the central and sector levels, which typically generate significant transaction costs in the initial period. These observations have been confirmed by partner governments in the SPA review³⁵, suggesting that harmonization and alignment have not yet resulted in significantly reduced transaction costs across the board. Similar skepticism has been expressed by Killick (2004)³⁶, who suggests that the rhetoric on lower transaction costs is not sufficiently evidence-based.

For recipient countries, it is likely that with increased provision of budget support, transaction costs will increase for the Ministries of Finance, whose capacity tends to be stretched by coordinating more reform programs under its responsibility. Donors on the other hand are also facing the challenge of enhanced engagement in policy dialogue with governments and new ways of interacting with each other.

Transaction costs by their nature are very difficult to measure. Four characteristics of transactions are typically thought to influence costs: frequency, complexity, uncertainty and specificity.³⁷ One of the rare studies that has attempted to gather quantitative information on transaction costs (Brown et al., 2000) developed surveys and carried out interviews on several indicators: (i) number of projects; (ii) number of reports; (iii) number of meetings; (iv) number of steering committees; and (v) total time civil servants spent on aid administration vs. policy making. However, measuring these indicators and gathering quantitative data, appeared to be a difficult and costly exercise.

³⁵ Special Programme on Africa (SPA) 2004. Survey of the Alignment of Budget Support and Balance of Payments Support with National PRS Processes, SPAC-6 Budget Support Working Group, January 2004

³⁶ Killick, T. (2004). "Politics, Evidence and the New Aid Agenda". In: Development Policy review 22(1):5-29 (January).

³⁷ See Doan and Lestrangle, 1998; Williamson 1998

Donor Coordination

Donor coordination has become a critical aspect of budget support, especially where it comprises a large share of donor flows. Better donor coordination, simplification and harmonization of donor requirements can contribute to local ownership, reducing the transactions costs and enhancing overall effectiveness of development assistance. Efforts to improve donor coordination are of course not new, but their effectiveness under different aid modalities was often limited by divergent donor procedures and the lack of common framework.

The institutionalized policy dialogue within budget support arrangements provides a promising framework for improved donor coordination and harmonization of policies, procedures and practices. Considerable benefits could also be expected from better alignment of donor budget support with the PRSP process and country priorities. Reviews of budget support to PRSPs in Benin, Burkina Faso, Mozambique, Malawi, Tanzania and Uganda point to significant progress on donor coordination and harmonization in these countries (Evans and Coyle, 2002).

Improved coordination and harmonization in budget support countries still faces significant challenges. In the first place, more effective donor alignment requires deeper analytical skills and implies greater management responsibilities for donors, both in headquarters and in the country. Challenges are higher in those countries in which there is no critical number of donors in favor of budget support, or the recipient country lacks the capacity or will to take a leadership role. Donors may disagree on how to determine whether recipient country has adequate capacity to effectively manage resources provided as budget support. Donor coordination is also hampered by different approaches to measuring fiduciary risks and the degree to which donors scrutinize budget and disbursement allocations. Despite common efforts at greater harmonization, donors still tend to conclude separate bilateral budget support agreements with partner countries, often with additional issues on the agenda. The SPA review shows that up to ten different donor missions were needed in some countries for assessing the public finance management system.

There is no single approach to donor coordination suitable to all countries and conditions, since the modality depends on local context and institutional capacity. However, emerging good practice suggests that the coordination framework should be articulated around several main alignment issues: (i) the recipient country aligns its PRSP implementation with its own budget cycle; (ii) donors align their budget support programs with the priorities set out in the PRSP; (iii) donors should coordinate their programs in order to achieve consistency in setting benchmarks and to harmonize procedures and documentation required; and (iv) donors should aim to synchronize the timing of their missions. The Paris Declaration on Aid Effectiveness pointed to the need to implement common arrangements for financing, disbursements, monitoring and evaluation, and the reduction of duplicative missions and diagnostic reviews.³⁸

³⁸ *Paris Declaration on Aid Effectiveness: Ownership, Harmonization, Alignment, Results and Mutual Accountability*, High Level Forum, March 2005.

9. Summary and Conclusions

Budget support has become an increasingly important instrument in the context of a partnership-based approach to development assistance. Donors and recipient countries alike have expressed an interest in exploring an aid modality that promises greater country ownership, reduced transaction costs, scaling up of poverty reduction and potentially greater development effectiveness than traditional modes of aid delivery.

Budget support is defined as a form of financial assistance provided directly to a partner country's budget on a regular basis, using its own financial management systems and budget procedures. In current usage, the term budget support typically refers to predictable, annual, medium-term resource flows, based on progress in achieving the objectives of the government's PRSP.

The rationale for an increasing emphasis on budget support has been provided by recent trends in the international aid architecture: shift away from traditional project support, shift from policy conditionality to partnership-based approach, greater emphasis on country ownership, shift from short-term to medium-term reforms, recognition of disruptive role of aid volatility and unpredictability, greater selectivity and enhanced focus on results.

The advantage of budget support over other aid modalities is that it allows for scaling up of funds aimed at poverty reduction in countries with strong ownership and a sound institutional and policy framework. This is facilitated by its characteristics of providing funds in a more predictable and sustainable manner, coordinating external financing with country's budget cycle, addressing cross-cutting issues and constraints to development, ensuring more efficient use of resources and supporting ownership and institutional capacity enhancement. Simplifying donor disbursement procedures and reporting requirements facilitates scaling up process.

Key characteristics of budget support include the channeling of donor funds to a partner country using its own systems; funds support a recipient country's own development programs linked to national or sector policies; conditionality is focused on policy measures related to overall budget priorities, as set out in the PRSP and MTEF; in principle there is no need for earmarking of funds for specific budget expenditures. However, if there are weaknesses in public financial management, additional accountability arrangements may be warranted.

An appropriate mix of instruments is needed to ensure the greatest effectiveness of development assistance. The mix depends on the degree of consensus on policies and budget priorities, and the institutional capacity of the recipient country to implement the reform program and account for an effective use of resources.

Key considerations in determining whether the conditions for budget support are appropriate include country ownership and accountability, selectivity and preconditions for effectiveness, macroeconomic issues, and fiduciary risk:

- Budget support is an instrument that encourages ownership by increasing the overall share of funds that are included in a national budget process, using a country's own system, reinforcing accountability relationships within recipient governments and strengthening their capacity to design and implement programs;
- Selectivity is critical to the effectiveness of budget support. It is most appropriate for countries with a good track record, strong ownership of the reform program, a reasonably sound policy and institutional framework, and commitment and sufficient capacity to allocate resources effectively;

- A stable macroeconomic environment provides a solid framework for efficient use of resources and helps maximize the effectiveness of budget support.
- Addressing fiduciary risk is both a precondition and one of the major objectives of budget support. If there is no adequate public financial management system in place, budget support may not be appropriate. Financial support in a form of sector wide approach or stand-alone projects could be considered in this case.

Key issues in designing and implementation of budget support program include the policy dialogue, tensions between predictability and performance, outcome orientation, institutional capacity, transaction costs, and donor coordination.

- The opportunity for an open dialogue on broad policy reforms and general budget priorities is an most important element of budget support arrangements. Enhancing the quality of the dialogue and including relevant policy issues requires continuous engagement and adequate skills by donors and recipient governments;
- Budget support may provide better predictability of medium-term flow of donor funds. However, the disbursement process can also be more prone to volatility;
- Budget support is results-based approach and its effectiveness should be measured in terms of outputs and outcomes. It also allows for scaling up of development effectiveness;
- By using the country's own procedures, budget support helps strengthening of institutional capacity. However, it also strains the capacity of Ministries of Finance. Donor capacity can also be an issue, as budget support requires specific analytical and other skills;
- The use of established government systems instead of parallel reporting and accounting systems for individual projects should result in reduced transaction costs. However, experience shows that costs are likely to be reduced only over the medium term, and could be even be higher in the short term;
- The institutionalized policy dialogue embedded in budget support provides a promising framework for improved donor coordination and harmonization. Challenges for the harmonization agenda including questions on how to determine the adequacy of a recipient country's financial management systems, varying preferences to scrutinize budget and disbursement procedures, and different approaches to respond to uneven country performance.

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