

## **Practitioners' Forum on Budget Support, Cape Town, South Africa, May 5-6, 2005**

The forum, organized by the World Bank, brought together a wide group of representatives of donors, recipient governments, international institutions and researchers with experience of budget support mechanisms, including related issues of aid coordination and conditionality. The forum immediately followed two days' discussion in the [Budget Support Working Group of the Strategic Partnership with Africa \(SPA\)](#). Key issues and recommendations identified by that working group were presented to the forum.

### Recent Developments in Budget Support

World Bank participants outlined the context for growing use of budget support, and some of the key issues to be addressed:

- Growing use of budget support resulted from disillusion with both traditional aid projects and the traditional approach to conditionality for policy based lending, recognizing the need to strengthen government ownership and systems, shift from supporting short term to medium term reforms, improve predictability of aid flows, exercise more selectivity between good and poor performers and increase focus on results. As an instrument it offers many benefits, including ease of scaling up assistance. But there are also concerns: about fiduciary issues and weak public financial management (PFM) capacity, lack of the visibility for donor support that is provided by projects, potential volatility of support, and donor coordination costs.
- Issues arising include: tensions between responding to differential performance and providing predictable support; finding ways to increase results orientation; shifting from a conditionality framework to a government accountability framework; improving PRS/policy action framework (PAF)/budget links to reconcile supporting a broad program with focusing on a few actions critical to success; and finding ways to reduce transactions cost while strengthening dialogue and donor coordination – both between donors, and between local donor offices and headquarters.
- Fiduciary issues. Donors, including the Bank, have to accept a degree of risk. Knowledge about country PFM systems has improved, but different donors have different risk thresholds. The Bank is prepared to provide budget support in certain cases where PFM is weak, so long as there is sufficient commitment to strengthen it. Stronger PFM is a key issue for development as well as for fiduciary risk.

A donor participant described progress to date with a joint multi-donor evaluation of budget support. A participant from a developing country stressed the important benefits of general budget support relative to sector or project support in helping finance ministries exercise necessary overall financial discipline – including ensuring coherence with the macroeconomic framework, and avoiding issues of fiscal space and “Dutch disease”. This was a recurrent theme throughout the forum, with both donors and recipient country representatives putting much stress on the benefits of general budget support in strengthening finance ministry control and PFM, and avoiding the impact that project and sector support provided to sector ministries too often had in undermining it. A donor participant noted that partly for this reason, as well as dissatisfaction with traditional project support, her agency is switching into budget support – with an aim of having 50% in that form in Sub Saharan Africa by 2007. She saw a major goal as being to strengthen countries’ PFM, and success in this regard would help in securing stronger backing in donor country parliaments for the budget support approach. Along with other donors she also stressed the need for effective assistance to help countries build PFM capacity.

### Budget Support and Programmatic Alignment

Presentations by ODI, World Bank and Japan Bank for International Cooperation (JBIC) participants noted the following issues:

- Achieving better donor alignment with country programs depends above all on leadership from recipient governments, which in turn depends on country political systems.
- The need for more action orientated PRS annual progress reports (APRs) linked to reformed and focused PAFs. The two together (other participants suggested the documents could be merged) should provide a basis for dialogue on a broader long term agenda linked to final results, while also focusing on a few short term critical actions to serve as benchmarks for support.
- Experience of budget support in South Asia, where the agenda is for second generation reforms, also reflects the importance of politics, including electoral politics, in countries where politics is often clientalistic rather than programmatic - which presents challenges. Budget support in these countries has helped generate ownership, enhance PFM, while providing flexibility on the timing of disbursements when progress is less than expected. Decentralization to both the state and district level presents a further challenge, although in some cases competition between states has been a positive factor.
- JBIC’s experience in Vietnam suggested that successful budget support requires strong prior country efforts to improve PFM and policies, suggesting that the process might take some time in many African countries.

- A World Bank study of experience in five countries suggested that the PRS process (widely defined) has been associated with: increased data availability, including better poverty analysis and a better results focus in medium term expenditure frameworks (MTEFs); increased openness in and scrutiny of budgets, both within and outside governments, leading to stronger links with sector strategies; and more generally better coordination within governments. At the same time parliamentary influence, while still weak, has been growing – but will not necessarily be a force for stronger poverty focus. PRSs seem particularly weak on measures to improve revenue generation. Donors have made progress in integrating support into the budget process – but could do more to reduce strains on governments by improving predictability, and aligning their timetables with national processes

Commenting, a recipient country finance ministry official emphasized the importance of donors understanding political context, and of the accountability of recipient governments first and foremost to their parliaments. He also stressed the need to strengthen capacity below ministerial level both to implement ministers' decisions, and to handle the dialogue with partners. The European Commission (EC) representative stressed the benefits he saw from incorporating results based triggers into budget support – not least as a way of strengthening donor country parliamentary support. Another participant noted the relevance of the NEPAD peer review process; and the need to remember other elements of the development agenda such as debt, trade and regional integration.

#### Predictability of Budget Support and Aid Dependency

Presenters from the World Bank analyzed evidence of variability of budget aid, and ways to make it more predictable. Recent evidence suggested that it is less variable over time than in the short run – but that while shortfalls reduce investment excess disbursements do not increase it. Recipients could insure against short run variability by building up and drawing on reserves. Donors could provide greater predictability at little cost by following existing practice of some and making predictable disbursements on a core of support – reviewed perhaps every 3 years – with perhaps a 10% tranche subject to annual variation. In discussion both ideas got support, though there were questions about rules for managing buffer reserves. It was also pointed out that the problem of in-year variability – with some disbursements not arriving until the end of the financial year – should in principle be easier to address, and that both that and improving longer term predictability would respond to country leadership.

A presenter from a recipient country central bank raised questions about the potential impact of too much budget support aid on the exchange rate and competitiveness (the “Dutch disease” issue). Others pointed out that the same consideration applies to many forms of project aid (and indeed other inflows such as remittances); that the cost may be modest when compared with the benefits of increased aid, particularly if aid flows are expected to continue over a long period; and that the issue could be addressed by

addressing domestic capacity constraints (such as numbers of teachers) and making investments with a high import content, by liberalizing trade, and if necessary using aid flows temporarily to add to reserves.

The Deputy Finance Minister from a post-conflict country spoke about the importance of budget support in his country, where over 90% of public expenditure is financed by aid. PFM and the budget process has been much improved. But with less than a quarter of aid flowing through the budget there was too much duplication between donors, too much use of international contractors and consultants, too much expensive technical assistance producing few results, with outside contractors and NGOs outbidding local employers for staff. This led to some discussion of the need for criteria for providing budget support to fragile states, and the idea that project aid did not necessarily provide the best answer in these circumstances.

### Aid Coordination and Conditionality

Presenters from the donor and research community suggested a number of issues for consideration, including the following:

- Where donors provide budget support they should consider whether there is any need to retain other aid instruments. They should also be ready to accept country driven and approved PAFs (as in Mozambique) as a basis for support. PAFs should include a limited number of process “conditions” (such as improvements in PFM); policy actions, which should be the subject of dialogue, not conditionality; and be set in a results framework which would determine long term but not short term aid allocation decisions. Other issues included graduated response mechanisms when conditions are not met; and performance indicators for donors.
- Conditionality can be regarded as a contract – and clarity of terms is important. But the terms – other than a few “showstoppers” - should impact only in the medium term. Results cannot usefully be assessed annually.
- Success depends above all on building trust between partners - with policy signals by recipients (such as reducing military spending), building local presence by donors, packaging and “charisma” all playing important parts.

A recipient country participant stressed the importance of coordination between donors, the need to get rid of multiple conditionality from different donors, for governments to take the lead in this respect, and for coordination also within governments – sector ministries should recognize they are part of the government team, and subject to budget constraints. An IMF participant described recent Fund experience with streamlining conditionality, stressing the need for pragmatism, and to find what works best for countries and donors.

Many participants noted the importance of building trust – not just between donors and recipients but on many other dimensions: between donors (a particular issue for EU countries); between local and head offices; between finance and sector ministries (with global “vertical funds” greatly complicating this relationship); between donor governments and their parliaments. Some noted the influence of trust and dialogue in donor choice of countries to support – probably more important than applying in-country conditionality; others the inherent tension between fostering the contacts needed to maintain trust, and reducing transaction costs. Many commented on the dangers of trying to measure and assess everything annually, particularly progress in achieving final results – some assessments and decisions are better made over longer periods. In this context it was pointed out that the difference between ex post and ex ante conditionality is not so great after the initial year of a programmatic operation. Several asserted that PAFs should be produced and presented by recipient governments, and perhaps approved by parliaments as in Mozambique.

A World Bank participant spoke about progress with the Bank’s review of conditionality. He noted changes already made – in the shift to programmatic forms of lending; in reducing numbers of binding conditions; and in setting World Bank operations in the context of budget support groups in many countries, with combined PAFs. For the future it seemed important to highlight ownership, though not in a naive way; to reduce conditions/benchmarks to a few truly critical actions; to accept that support cannot buy reforms; and to accept roles for process, policy and outcome benchmarks in different circumstances.

### Concluding Panel Discussion

Panelists drew a number of central conclusions from the proceedings.

- While progress has been slow, we have come a long way for the Bank to be able to mount such a forum on budget support. But we are still learning how best to use the instrument.
- Aid effectiveness is the issue, with a strong message that budget support enhances effectiveness in achieving poverty reduction and growth. It provides a way to support key priority sectors without undermining budget integrity: an emerging issue is how to prevent sector and project support doing so.
- Trust is important and can be seen as a dimension of selectivity. Imposing conditions chosen from countries’ own policy frameworks, which should be normal practice, does not signal lack of trust.
- Predictability is important and may point to making some decisions at longer than annual time intervals. Donors may have to take more risks in this respect – but recipient countries are also accepting risk from variability in budget support. (Short term in year predictability should be more easily solvable).

- The search for ways to strengthen donor accountability for implementing Paris commitments to alignment and harmonization should continue – with a possible role for independent monitoring groups or regional mechanisms. More radically, could donor presence in individual countries be streamlined?
- Improved PFM is central. There is probably already sufficient donor support, but it needs better coordination/less duplication, with more recipient country leadership. Capacity building in this and other areas may require attention to public sector pay levels for key staff.
- Budget support has also revealed the need for improved monitoring and evaluation – with corresponding strengthening of country statistical capacity. While final results are not always a good basis for conditionality, their measurement – and tracking links with policy actions – has to be a key part of country dialogue.
- While conditionality has sometimes worked in the past, for example in supporting reformers in implementing fiscal discipline and exchange rate reform, it has not proved effective in strengthening performance in weak policy environments. The question now is to find ways to transfer the experience of strong reformers – the main recipients of budget support – to “mid” reformers. In weak performers, where policy is the main constraint to progress, budget support can also have a role. Further discussion is needed about the right balance between budget and other forms of support in different country circumstances.
- The Fund’s support for sound macro policies sets the scene for budget support – but an increase in budget support can in turn pose challenges for macro policy, not only of potential “Dutch disease”, but also of potential volatility of flows and of debt sustainability where some of the support is debt creating. The Fund is seeking to develop a form of signaling about the quality of macro policy that will be less of an on/off switch for donors; and also to make a stronger contribution in the field to the work of multi-donor budget support groups. It is also working on new proposals to provide support for countries subject to exogenous shocks.