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Working Party on Aid Effectiveness and Donor Practices

DRAFT GOOD PRACTICE NOTE ON THE PROVISION OF BUDGETARY SUPPORT - A PUBLIC FINANCIAL MANAGEMENT PROSPECTIVE

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This paper is presented for DISCUSSION at the next meeting of the Joint-Venture on Public Financial Management to be held on 17-18 November 2004. It was elaborated by the European Commission in close collaboration with the World Bank and IMF.

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I. KEY ISSUES

1. From an economic viewpoint, most types of aid provide some support to the budget of the recipient country in a more or less direct way. For the purpose of this paper, however, budget support is more narrowly defined as a method of financing a partner's budget through a transfer of resources from an external financing agency to the partner government's National Treasury. The financial funds thus transferred are managed in accordance to the beneficiary's budgetary procedures. Funds transferred to the National Treasury for financing programmes or projects managed according to different budgetary procedures from those of the partner country are therefore excluded from this definition of budget support.

2. Budget support can be further categorised according to its principal aims. In the case of general budget support (GBS), for instance, the focus of dialogue and of disbursement conditions is on overall policy and budget priorities, whereas for sector budget support (SBS) the focus is on sector-specific concerns. While many of the good practices identified below apply to all types of budget support, the focus of this chapter is on GBS with a separate chapter dealing with SBS.

3. Apart from being particularly well-suited for macroeconomic stabilisation needs, budget support offers the prospect of reducing transaction costs, facilitating donors' co-ordination and enhancing the predictability of aid flows. It also constitutes a potentially effective tool to improve allocative efficiency in recipient countries' public spending, and strengthen their policy ownership. Finally, by channelling aid resources through the government budget, it fosters institutional development and increases accountability by underscoring the budget's role as the statement and tool of government policy.

4. Budget support, however, also has potential disadvantages for the recipient countries. These include the possibility of significant volatility in aid flows; the fiscal adjustment costs that a suspension of budget support would entail; the risk of more intrusive and extensive conditionality; and the likelihood of heavy reporting requirements, especially in the fiduciary area.

5. A donor's decision to provide budget support would depend on several factors. These include an assessment of the public financial management systems and the likelihood that the resources would be used appropriately, as well as of the existing fiduciary safeguards. Donors will also compare the potential benefits and risks of providing budget support. Since the former are not automatic and the latter are not inevitable, however, implementation is key once the choice to provide aid in the form of budget support has been taken. Accordingly, this chapter identifies the good practices for donors once such a decision has been taken. In doing so, the chapter:

6. Complements the good practices already agreed in the field of donors' harmonisation. **[***footnote bibliographical reference***]**

7. Relies on the increasing experience with the provision of budgetary support gained by DAC's members, international financial institutions and recipient countries.

8. Approaches the issue from a public financial management (PFM) perspective given the particular importance of public financial management systems in recipient countries for the effectiveness and accountability of budgetary support.

[Further insights on good practices will become available following the finalisation of the on-going multi-donor evaluation of the impact of budget support in 2005.**]**

II. PURPOSE

9. The purpose of this chapter is to put forward a set of good practices on how donors can best deliver budget support in a way that effectively supports the capacity of a recipient country's PFM system to achieve its fundamental goals, namely aggregate fiscal discipline, a strategic allocation of funds, value for money and probity in the use of public monies.

10. The chapter seeks to provide benchmarks for donors' behaviour in the provision of budget support. It neither aims to prescribe recipients' behaviour nor identify which characteristics of their PFM systems would be most appropriate for the provision of budget support. Since the latter, however, can significantly influence donors' readiness to provide budget support as well as their capacity to follow best practices, reaping the benefits of budget support will often require a collaborative effort between donors intending to follow best practices and recipients willing to reform their PFM systems. Key features of a strong PFM system are identified in annex [I].

III. GUIDING PRINCIPLES

11. The following principles guided the elaboration of this chapter's good practices:

12. **Budget support should support partner countries' ownership** – By granting fungible resources for the financing of budgetary outlays, providers of budget aid support the overall set of policy priorities embedded in a country's budget law. While this raises a justifiable need to discuss with the recipient government budgetary goals (and related funds allocation decisions), sustained policy implementation ultimately depends upon the existence of strong political commitment. Budget support should therefore not attempt to leverage policy actions where such commitment does not exist.

13. **Budget support should help to enhance the performance and accountability of partner countries' PFM systems** – Budget support gives donors a legitimate interest in the strengthening of the PFM systems through which their funds are spent. For both developmental and fiduciary reasons, donors should use the provision of budget support to foster the improvement of recipients' PFM systems.

14. **The transaction costs incurred by recipients of budget support should be minimized** – The fact that aid provided in the form of budget support is spent following national procedures is an inherent source of transaction costs savings. In order to safeguard value for money, however, other transaction costs attached to budget support – such as those incurred through multiple large-scale PFM assessments - should be kept to a minimum.

15. **Budget support should be delivered in a way that enhances the predictability of resources and reduces their volatility** – When drafting their budgetary plans, recipient countries' authorities should be able to count upon reliable estimates of the amount of budget support available, the timing of its disbursement and/or the conditions for its release. For recipients' budgetary authorities, predictability is an important requirement with respect to both the short term disbursements of committed aid and the early

commitment of future aid flows for the medium-term. Higher predictability (or lower volatility) facilitates the implementation of policies geared towards macroeconomic stabilisation, the design (and implementation) of medium term expenditure frameworks, the strategic allocations of funds across policy priorities and the rational choice of the least costly financing strategies. However, experience shows that the actual timing and size of budget support commitments and disbursements are subject to a certain amount of variability. While this is partly due to beneficiaries' behaviour, donors should seek to eliminate those sources of volatility under their control.

IV. GOOD PRACTICES

Supporting ownership

16. **Untargeted support -** As a norm, there should be no restrictions on the use of funds once these are transferred to a beneficiary's treasury account. Given resource fungibility, the earmarking of resources would have little or no positive impact on the effectiveness of aid, but it would increase transaction costs. Exceptions to the general rule should be limited to clearly justified cases such as when significant risks of severe liquidity constraints raise the possibility of cuts in priority spending.

17. **Reflecting partner country priorities -** Conditionality should draw as much as possible on the authorities' policy agenda and objectives, most typically as reflected in the programmes and targets presented in national development strategy documents, particularly the PRSP, and in the annual PRSP review.

18. **Focus on results.** Budget support should increasingly focus on results rather than on leveraging policy action. This creates decision-making space for the recipient governments, increases their accountability and gives them an incentive to monitor and reflect on the progress achieved towards stated goals rather than concentrating solely on inputs and policy design. Increasing focus on results complements, rather than substitutes for, the dialogue between donors and partner countries on the underlying policies and the related provision of technical assistance. Increased focus on results can be achieved in several ways, including, but not exclusively, through the use of service-delivery indicators and/or conditionality. However, the evolution towards a greater focus on result is a difficult issue in practice, not least because of the need to identify clearly monitorable indicators.

Enhancing PFM performance and accountability

19. **Follow good practices in PFM diagnostic and assessment work** – Donors should abide by the existing DAC guidelines for measuring performance in public financial management **[***insert bibliographical reference***]** (see also box 2 below)**.** Donors should also share the results of their own diagnostic and assessment work, and base their decisions on the results of work done by others, to avoid burdensome and costly repetition.

20. **Directly support the strengthening of PFM systems** – Budget support should directly encourage the improvement of beneficiaries' PFM systems. This can be done in alignment with a partner country reform strategy through the inclusion of specific conditionality and the provision of targeted technical assistance. Increasing involvement of the recipient countries' auditing authorities in PFM assessments and ex post audits, for instance, could greatly contribute to the transfer of know-how.

21. **Avoid undermining country systems** – Given the varying standards of expenditure management among partner countries and the accountability requirements of donors, budget support providers cannot always fully rely on partner countries' systems for expenditure and control. Ex ante and ex post assessments, safeguards and additional reporting requirements can therefore be justified. They should,

however, be carried out in a way that leads to the strengthening of countries' systems rather than their substitution by temporary and donor-specific parallel arrangements.

Reducing transaction costs

22. **Streamline conditionality** – Since there should be only one budget and one national strategy to be implemented through it, budget support providers should link funding to a single framework of conditions and/or a reduced set of indicators drawn from the partner's PRSP, and its annual review or equivalent national framework, jointly agreed on with the partner government. This does not mean that all donors should have identical conditions, only that each donor's conditions should be derived from a common framework. Whenever possible, conditions should be drawn from the partner's PRSP, its annual review or equivalent national framework. Other conditions could be agreed when a sound justification existed and as long as this was the result of a transparent process involving other budget support providers and granting the partner government the time necessary to review and consider alternative policy options. In any case, conditions and indicators should be limited to those that facilitate the achievement of, or measure progress toward the salient elements of the PRS. While practice has shown this to be a difficult result to achieve, encouraging progress has been recorded in a number of cases.

Box 1. The case of Mozambique

Budget support donors in Mozambique have been organised in a joint process since 1998. The number has now grown to 15, including the World Bank, plus several observers including UNDP. They commit to consulting Government only through joint missions, organised around the *Plano Economico e Social* (PES, the annual implementation plan of the PARPA, Mozambique's PRSP), which is submitted to the National Assembly for approval before the financial year starts and on whose outcomes Government reports (in a *Balanço do PES*) about three months into the subsequent year. All donors have signed an agreement to derive their disbursement triggers from a single common Performance Assessment Framework, negotiated annually, whose indicators are drawn from the PES. A common assessment is made of progress with implementation of the PARPA, based on the *Balanço do PES*, and individual donors then take their own decisions on whether to disburse and, if so, how much. The Memorandum of Understanding in which this is formalised also defines a number of underlying principles (including governance and human rights, macro-economic stability, and poverty reduction) essential for the continued provision of budget support.

23. **Rationalise fiduciary assessments –** Donors have different accountability requirements and therefore have a legitimate need to satisfy their specific fiduciary concerns attached to budget support. In doing so, however, they should reduce the burden on partner countries through fewer, better co-ordinated and, to the extent possible, common diagnostic reviews. These should provide a common pool of information donors could draw upon to reach their individual fiduciary decisions.

Box 2. PEFA

Donors presently use a variety of different diagnostic tools to assess the strength of public financial management systems in recipient countries. An effort is now underway by a joint World Bank, IMF and Public Expenditure and Financial Accountability (PEFA) Secretariat working group to develop a common performance measurement framework for monitoring PFM performance, working in consultation with the Joint Venture. The aim is to streamline donor diagnostic work, and increase the focus of donor PFM capacity building support by encouraging a common approach around a core set of PFM issues and by removing duplication of analysis.

The framework comprises a PFM performance report, which is an integrated assessment based on a standard set of high-level PFM indicators **[***insert reference to common annex***]**. Building upon the HIPC AAP, the framework aims to offer a credible monitoring tool to inform donors' fiduciary decisions, to feed into the policy dialogue between government and donors, and to provide government with objective feedback on the major areas of weakness and on the impact of reforms. PEFA partners expect to complete the on-going technical testing of the indicators and the performance report by end-2004.

24. **Process alignment** – Donors should individually and collectively align their dialogue and monitoring processes with the beneficiaries' national budgetary cycle of policy formulation and implementation and rely as much as possible on beneficiaries' reporting and monitoring systems for their own reporting purposes. **[***Insert bibliographical reference to DAC guidelines for reporting and monitoring***].** For example, donor reviews should be designed as far as possible to use the data and information generated by the country's own monitoring and evaluation requirements.

25. **Tap the potential of joint donor frameworks –** The drive towards increased harmonisation has led to the creation of donor groups on a country-by-country basis. These are often formalised through the drafting of "joint partnership frameworks" that outline the basic principles of donors' collaboration and often contain a "common assessment framework" as the basis for reviews and disbursements. While these frameworks carry with them the potential of reducing transaction costs, this objective cannot be taken for granted and donors should carry the burden of start up costs. Frameworks should be streamlined and as simple as possible. Particular attention should be paid to the risk of creating additional layers of institutional processes and of reaching agreement on common assessment frameworks simply by adding into a single list the individual concerns of all partnership members.

Box 3. The case of Tanzania's PRBS / PRSC

In Tanzania, all fourteen budget support development partners agree to the Partnership Framework Memorandum, which outlines the principles of cooperation and harmonisation, with the objective of reducing transaction costs for Government. This leads to a joint process of appraisal, review and dialogue with the authorities on PRBS-related matters. The review of progress against the PAF (Performance Assessment Framework) is structured around working groups to achieve burden sharing among donors. In order to achieve closer alignment with the PRS, this framework is expected to evolve, in particular through the adoption of the PRS monitoring and review process.

26. **Time disbursements to facilitate the smooth execution of budgetary payments** - In the presence of well-known seasonality in cash flows, donors should agree with the budgetary authorities on the most appropriate timing for the (planned) release of budget support resources. If deemed relevant, seasonal macroeconomic patterns should also be taken into account. When more than one donor is providing budget support, donors and recipients' authorities should co-ordinate to spread individual disbursements across the fiscal year in the most appropriate way, and this information should be taken into account in the design of the macroeconomic and monetary programs for the coming year.

Enhancing predictability and reducing volatility

27. Multi-year programming – Donors should redouble their efforts to programme and (subject to performance) commit budget support over a rolling multi-year framework in order to match the timeframe for partners medium-term budgetary planning. Indications of the overall envelope of this medium-term support should be provided to the partner authorities as early as possible.

Box 4. Examples of some existing multi-year arrangements

Programming of **IMF concessional financial assistance** under the Poverty Reduction and Growth Facility (PRGF) covers a three-year period. The main macroeconomic objectives are agreed at the outset of the period and the policies for achieving these are set out in annual programmes, upon which programme conditions and disbursement triggers are based. There are two semi-annual disbursements, the first on approval of the annual programme, the second on the completion of its mid-term review, which can be delayed by slippages in programme implementation. Programming of **World Bank support**, as reflected in the CAS, covers periods varying from 3 to 4 years. Within this framework, PRSCs are multi-year commitments to providing budget support to partner countries with indicative yearly amounts. Reviews and disbursement triggers for the various tranches are finalised annually. So far, PRSCs have never been discontinued for countries eligible to programmatic budget support.

Programming of all **EC aid** is currently based upon a five-year horizon with budget support generally granted on the basis of a three-year agreement. DFID or other bilaterals to contribute.

28. **Compatibility with partner government cycles** - Budget support commitments should be aligned as closely as possible with the recipient's budget cycles. Donors should provide early indicative commitments to facilitate budget planning, and strive to complete negotiation in time to permit final commitment before the start of the new budget year.

Box 5. Uganda's discounting of budgetary aid forecast

In view of the observed volatility in budget support flows, Uganda's Ministry of Finance "discounts" donor aid projections when preparing its budget. Revised periodically in light of the most recent aid performance, the discount factor for budget support is currently set at 35%, corresponding to average level by which disbursements have fallen short of donor commitments over the last five years. For any given deficit goal, the discounting of donors' projections adds realism to the government financing plans and associated monetary programme, thus allowing a more robust assessment of the macroeconomic sustainability of the deficit target and its underlying expenditure ceilings.

29. **Design conditionality to enhance the predictability of disbursements** – The availability of budget support funds can never be guaranteed up-front when disbursements are subject to the fulfilment of conditions. Donors should therefore design conditionality in such a way as to make the disbursement of funds as predictable as possible in terms of its timing and magnitude. This would allow the partner country's budgetary authorities to rely on sound estimates of the funds likely to be available as in the case of other revenues. Ensuring such a result depends on several factors including: (This section needs to be coordinated with the good practice paper on predictability, which, inter alia, suggests conditionality in year t should affect disbursements in year t+1).

30. *The timing of the review of performance* – Verifying the fulfilment of conditions as early as possible extends the period during which the partner's budgetary authorities are aware of the actual amount of budget support that will be disbursed, and allows them to adjust their spending plans in a more rational and controlled manner. When possible, zero in-year variability should be sought for instance by specify in year *n* disbursements for year *n*+1. Other **[**more far-reaching**]** arrangements could also be envisaged as described in box 6 below.

Box 6. The HIPC initiative and "threshold conditionality"

By granting irrevocable debt relief at the completion point, the enhanced HIPC Initiative in effect awards an irreversible stream of budget support flows over the medium term to those countries which have proved their willingness to implement sound macroeconomic and sectoral policies by successfully meeting a set of pre-defined criteria, such as maintaining a stable macroeconomic framework, the satisfactory implementation of the PRSP, and other policy actions, which reflect the country's priorities. Combining what can be viewed as an extreme form of floating tranche conditionality with binding multi-year commitments, the HIPC Initiative is unique in providing fully predicable support over the medium term regardless of any concern that may arise after completion point.

Given the need for stable financing flows for the achievement of the MDGs, the importance partner countries attach to predictable aid flows and the difficulties encountered in providing them through more traditional arrangements, the donor community may want to reflect whether similar mechanisms could be applied outside of the specific context of external debt cancellation, i.e. whether countries clearing a certain "performance threshold" defined in terms of set criteria could be awarded irrevocable multi-year support. The latter could complement, rather than substitute, existing instruments.

31. *The clarity of conditionality and of its evaluation process* - The conditions attached to disbursements and the process through which their fulfilment is assessed should be clearly specified and leave little margin for interpretation, thus reducing the uncertainty surrounding disbursement decisions. This implies that specific conditions should be preferred to vaguely-

defined ones **[**such as **"**the successful conclusion of a joint-donors review of PRSP implementation"**]**. Similarly, while the evaluation of conditionality should not be reduced to a mechanical exercise, the lines of responsibility for disbursement decisions should be clearly established to ensure transparency and allow recipients governments to understand fully the basis for these decisions.

32. *Political conditionality* **–** While prohibited in the case of the international financial institutions, political conditionality can be legitimate for other donors. Political sensitivities are also likely to be more intense in the case of budget aid since some constituencies may see the provision of budget support as an endorsement of the partner country's overall policy stance. However, the very nature of political conditionality makes it difficult to come to formulate clearly defined conditions that leave a very limited margin of interpretation as suggested by the previous best practice. Accordingly, political conditionality should not be specifically linked to budget support or any individual aid instrument but rather should be dealt with in the context of the overarching political dialogue between a recipient country and its donors.

33. **Predictable disbursement lags -** Disbursements should be timely. Following the positive review of conditionality, disbursements should occur promptly or at least within a well defined timeframe. Donors should re-examine their current disbursement and authorization procedures to reduce the uncertainty surrounding the timing of disbursement following a positive assessment of conditionality.

34. **Avoid stop-and-go cycles and allow for graduated responses** – Depending on the share of a country's public accounts financed through budget support, the suspension of aid by all donors can be particularly disruptive, leading to an unintended excessive response to the underlying policy slippage and introducing significant additional macroeconomic volatility. Various mechanisms can help limit these risks:

35. *Avoid the bunching of conditionality around a limited number of common criteria.* Measures to reduce this outcome could include a more co-ordinated ex ante approach to the distribution of key conditionality across budget support providers. In the case of the common requirement for a positive conclusion of an IMF review, donors should be prepared to maintain their flows of budget support even in the event of minor slippages that may delay completion of the formal IMF review, provided that the macroeconomic framework remains satisfactory, and the slippages do not call into question the overall implementation of the PRS. In such cases, the IMF should produce and share with donors a timely analysis of the macroeconomic situation.

36. *Avoid institutionalising the principle of unanimous donors' agreement*. Harmonisation is different from unanimity. Whether formalised or not, joint processes should preserve the space for different donors to take different decisions on the basis of the same evidence. Donors participating in joint donor frameworks should reach agreement on the circumstances under which their support would be individually or collectively adjusted or reduced, as well as the modalities of such adjustments, so as to enhance the predictability of resource flows.

37. Allow for partial disbursements in case of partial fulfilment. Such a mechanism can reduce the volatility of budget support by establishing an intermediate option between withholding all funds and releasing them anyway. To the extent that partial disbursement decisions are based on well-specified rules, predictability also increases relative to a situation where a donor's decision to disburse fully despite partial fulfilment is based on opaque and subjective judgements. One method currently applied to provide for graduated response is the fixed and variable tranche mechanism utilised by some donors (see box 7 below). Another possible arrangement would be to devise budget support as a set of multiple flows, each subject to its own specific array of conditions. In the simplest of cases, this would twin a macroeconomic and a sectoral tranche. While some funds could then, for instance, be withheld in case of a delay in an IMF programme review, the remaining funds could still be disbursed if sectoral conditionality was being met, thus allowing the continued financing of a sector despite the existence of some problems at the macroeconomic level.

Box 7. EU and Switzerland: fixed and variable tranche mechanisms

In most cases, the EC's budget support programmes envisage a **fixed and variable tranche** disbursements. The **fixed tranche** components are basic resources in terms of macroeconomic support and are disbursed in "all or nothing" form depending on the continued fulfilment of eligibility conditions pertaining to economic management and PFM conditions. The **variable tranche** components are additional resources that are released in a graduated form depending upon the extent to which targets and performance indicators agreed with the Government within the framework of the country's PRS are achieved.

Switzerland has also adopted similar arrangements. In the case of Mozambique, for instance, half of the funds provided through budget support is disbursed as a fixed tranche based on an assessment of macroeconomic developments, more generally, performance against commitments in the PAF. The remaining funds are disbursed through variable tranches linked to PFM performance (20% of all funds), revenue mobilization objectives (15%) and performance in private sector development (15%).

By adopting fixed and variable tranches, both the EC and Switzerland aim to increase the predictability while maintaining incentives for progress in selected areas.

38. **Protect public support -** Donors should engage in an active communication strategy towards their political constituencies and civil society in order to enhance the understanding of budget support, its opportunities and the related risks. An informed discussion on the benefits of budget support will help to create more awareness of the long-term commitment required by this form of direct support, mitigating the risk of disruption based on factors that are in the donor's hands. A better understanding of budget support and of the related importance of countries own systems and priorities will furthermore provide an incentive for donors to move the policy dialogue away from narrowly defined individual agendas.