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DIRECTORATE-GENERAL FOR EXTERNAL POLICIES

POLICY DEPARTMENT

THE FUTURE OF EU BUDGET SUPPORT IN DEVELOPING COUNTRIES

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EUROPEAN PARLIAMENT

DIRECTORATE-GENERAL FOR EXTERNAL POLICIES OF THE UNION

DIRECTORATE B

POLICY DEPARTMENT

BRIEFING PAPER

THE FUTURE OF EU BUDGET SUPPORT IN DEVELOPING COUNTRIES

Abstract

This present study is a contribution to the recently launched consultation process on the future of EU budget support to third countries. It provides evidence-based answers to the 20 questions raised in the Green Paper which focus on the following aspects:

- Political governance and the role of the political dialogue
- Role of policy dialogue, role of conditionality, links to performance and results
- Domestic and mutual accountability
- Programming of budget support and its coherence with other instruments
- Strengthening risk assessment and dealing with fraud and corruption
- Budget support in situations of fragility

Growth, fiscal policy and mobilisation of domestic revenues.

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EXECUTIVE SUMMARY

Overall, the EC Green Paper is quite comprehensive and raises the most important issues that need to be taken into consideration to improve the design and management of budget support. Two aspects, however, are not dealt with to the extent necessary. On the one hand, the Green Paper does not directly put into question the EC's eligibility criteria for budget support. Donors, however, apply different criteria and some are stricter than others. The issues of political governance and underlying principles, for instance, need to be considered before budget support is provided. On the other hand, attention should be drawn on the extent to which domestic accountability in donor countries affects approaches in partner countries.

The first issue of the Green Paper deals with political governance and underlying principles and the extent to which this can or should be taken up in budget support conditionality. In general, political conditionality should not is not only be linked to the provision of budget support but to any other aid instrument in a given or potential partner country. If a country is severely violating underlying principles it should not be eligible to receive budget support in the first place. The Commission should therefore consider including the respect for underlying principles or the government's commitment to improve the human rights situation in their eligibility criteria.

With regards to the policy dialogue and the role of conditionality, the Commission is advised to consider that reforms cannot be 'bought' by donors and that ownership is a key factor for any positive development outcome. The key focus of any budget support operation has to be an intensive and equitable policy dialogue between donors and the government in which the conditionality is mutually agreed on. Conditionality, however, cannot replace ownership and donors have to be careful to ensure that agreed reforms are demand-driven and supported by the government. In general, conditionality should not represent a wish list of donor priorities but focus on a limited number of mutually-agreed key issues or reforms, aligned with the national poverty reduction strategy. In addition, the Commission should make sure that the achievement of conditionality is independently assessed. Strengthening domestic accountability is a particularly important issue for budget support to succeed. Thus, budget support processes should be as transparent and inclusive as possible.

Parliamentarians and civil society actors have to be systematically included in the policy dialogue and annual reviews, while especially the information flow between donors and parliamentarians needs to be improved. The Commission should focus on a more nuanced political analysis that takes into account drivers and constraints to improved domestic accountability. Based on this analysis, capacity development of key actors of domestic accountability such as parliament, civil society organisations and the media should be actively supported. The Commission should also better balance budget support funding and support to domestic accountability and develop overarching strategies to support actors of domestic accountability across focal sectors.

Overall, the EC should apply a mix of instruments in a partner country. Decisions whether to provide general budget support, sector budget support or other programme-based approaches has to be done on a case-by-case basis and based on experiences made in a given country. The Commission, however, should be careful that potential benefits of budget support such as ownership, alignment, increased accountability etc. are not undermined by having too many instruments in place which are channelled outside the budget, i.e. project aid, basket funds. Most importantly, sector approaches have to be aligned with partner country systems. In this light, the Commission should not only raise the question whether or not general budget support and sector budget support can be used alongside but rather focus on the need to increase sector budget support vis-à-vis other programme-based approaches that are channelled outside government's budgets and rely on parallel management systems.

Fiduciary risk management should be openly discussed by the Commission. Presently, the EC Guidelines do not directly mention fiduciary risks or how these fiduciary risks can best be managed and controlled. Therefore, the Commission should develop a comprehensive and systematic fiduciary risk management strategy which includes (i) a fiduciary risk assessment, going beyond the assessment of the public financial management, (ii) a strategy to mitigate risks and (iii) the monitoring of the performance.

Many opponents or critics of budget are particularly worried about potential misuse of funds, corruption and fraud in partner countries. However, there is no clear evidence that budget support is more affected by corruption than other aid modalities. Some argue that budget support increases donor's incentives to deal with corruption and fraud in partner government's financial management systems and that budget support increases the visibility of corruption. Other studies argue that high levels of political corruption are the major cause for bad performance of budget support. The above mentioned fiduciary risk management provides a good tool to identify if corruption risks have improved or even deteriorated. In addition, the Commission should make sure that governments are willing to tackle corruption and raise the issue in the policy dialogue.

The question, if budget support should be provided to fragile states cannot simply be answered with 'yes' or 'no'. It is a particular sensitive and challenging decision, and donors should avoid one size fits all proscriptions such as 'budget support is inappropriate in fragile states' or 'civil society organisations are the answer'. Budget support to fragile states can have positive effects. In East Timor or Afghanistan, the use of trust funds has had a potentially positive effect, while direct budget support to Rwanda and Sierra Leone has contributed to stability, restoration of institutions, government ownership and strengthening financial management capacity. Even though decisions have to be made on a case by case basis, the Commission should develop a strategic approach to working in fragile states, which takes into account the level of fragility, the political will and reform orientation of the government, fiduciary risks, and the extent and degree to which donors can meaningfully cooperate with the government.

To promote inclusive and pro-poor growth, EU budget support must be designed to engage with partner countries on a long-term basis and to provide aid predictability. Short-term assistance is unlikely to be productive, unless it complements and is well co-ordinated with more long-term development interventions. The MDG contracts which the Commission launched in 2008 are clearly a step in the right direction. Budget support conditionality should build on priorities agreed on in the poverty reduction strategy paper of a partner country. At the same time, the Commission should further support participative and inclusive poverty reduction strategy processes to make sure that poor people's priorities are taken into consideration.

Domestic revenue generation is particularly challenging in many developing countries, especially in sub-Saharan Africa. Donors, however, rather focus on the expenditure side and too little on the income side of the budget. The Commission should increasingly use the policy dialogue as leverage to support tax reforms and improved domestic revenue generation. To do so, donors should focus primarily on tax reforms, tax policy and tax administration at national and local level and on capacity development of key institutions such as revenue authorities. In addition, in national resource rich countries, initiatives such as the Extractive Industries Transparency Initiative (EITI) should be included in the policy dialogue and in the budget support conditionality.

Promoting regional integration is particularly important in Africa. Budget support works mainly at the national level, its modalities and effects should also take account of the commitments for regional integration. The EU can support partner countries in Africa to further the process of regional integration by addressing the challenges impeding the flow of goods and services within the continent. Funding mechanisms at the regional level pose significant challenges and budget support to regional economic communities is not yet a common practice. The commission should consider the possible introduction of budget support to regional economic communities cautiously. Presently, budget support is designed for national governments and national contexts. If donors consider expanding budget support to supranational contexts, the design and implementation as well as fiduciary risk management would have to be adapted accordingly and carefully thought out.

General Budget Support: Potentials and Risks

1. Political governance and the role of the political dialogue	**Potentials:** • leverage of budget support dialogue is enormous and regarded as more effective than any other political exchange • budget support can always be suspended if underlying principles are breached
	Risks: • GBS is used as a donors' tool to impose their governance or human rights understanding which inevitably undermines national ownership • donors have to be careful to cut budget support if the political stability of a country is in question
2. Role of policy dialogue, role of conditionality, links to performance and results	**Potentials:** • budget support policy dialogue improves collaboration of donors and the government and can build on and reinforce partnership • conditionality supports government to implement reforms and focuses on results
	Risks: • conditionality represents a wish list of donor priorities and undermines domestic political decision-making • conditionality is too ambitious, unrealistic and achievement is not independently assessed
3. Domestic and mutual accountability	**Potentials:** • budget support strengthens domestic accountability and underlies parliamentary control • budget support reduces parallel management systems and strengthens national audit systems • external and domestic accountability are complementary and reinforcing
	Risks: • donors do not include civil society or parliament as much as necessary • support to domestic accountability and budget support are not in reasonable proportions • external demands for accountability overshadow and undermine domestic accountability
4. Programming of budget support and	**Potentials:** • General budget support and sector budget support are

its coherence with other instruments	complementary. Sector budget support can make cross-cutting reforms more responsive to the needs of sector service delivery • Project aid targeted at supporting the Supreme Audit Institution, Revenue Authorities or other public financial management institutions can reinforce partner country's capacity to manage budget support • Funding for civil society and research institutions increase domestic accountability • Budget support policy dialogue can be used as a platform to address issues arising in specific sectors
	Risks: • Donors continued use of project aid undermines the potential benefits of budget support • Donors rather use basket funds that sector budget support to minimise risks, but undermine domestic accountability and build up parallel management systems • Policy dialogue is too ambitious and overloaded
5. Strengthening risk assessment and dealing with fraud and corruption	**Potentials:** • Budget support strengthens financial management systems as well as domestic accountability systems and improves the control environment. • Budget support increases donor's incentives to deal with corruption and fraud in public financial management • Budget support increases the visibility of corruption
	Risks: • high levels of political corruption are the major cause for bad performance of budget support • corruption outweighs development benefits • funds are not used appropriately and do not reach local levels
6. Budget support in situations of fragility	**Potentials:** • budget support to fragile states contributes to stability, restoration of institutions, government ownership and strengthening financial management capacity
	Risks: • high fiduciary risks • very weak government structures • legitimation of governments unclear
7. Growth, fiscal policy and mobilisation of domestic revenues	**Potentials:** • budget support can strengthen tax reforms and administration • policy dialogue can be used to support transparency initiatives in resource rich countries • budget support leads increased predictability of aid if planned long-

	term
	Risks: • budget support minimises government's incentives to mobilise domestic resources • donors rather focus on the expenditure side and too little on the income side of the budget • budget support disbursements are often not predictable • quantitative measurable targets could create unwanted negative incentives

INTRODUCTION

Overall, the Green Paper is quite comprehensive and addresses most of the key issues with regards to budget support. Two aspects, however, are not dealt with directly:

- **Eligibility criteria**: The question if the EU's eligibility criteria for budget support are appropriate is not directly raised. Some related aspects are taken into account, for example the question whether to introduce minimum requirements for public financial management systems. However, eligibility criteria also have to be discussed within the framework of underlying principles and governance in the wider sense (not only connected to PFM).
- The extent to which **domestic accountability in donor countries affects approaches in partner countries.** If we talk about budget support and contentious issues, do we focus on effectiveness in partner countries or on what can be better justified at home? The use of variable tranches, for instance, are they really effective for improving GBS in partner countries or are they rather a good measure to please the public in donor countries? The use of GBS or SBS is another example. In practice both instruments are not too different but SBS can be sold better to the public. Any switch to SBS, however, should rather focus on the effectiveness of the instrument in the partner country.

1 POLITICAL GOVERNANCE AND THE ROLE OF POLITICAL DIALOGUE

Q1: Should budget support operations (especially general budget support) be designed to better reflect partner countries' commitment to the underlying principles and if so, how? In particular, should budget support programmes make more use of political governance conditionality? Is there a case for adopting a different approach to political conditionality for general as opposed to sector budget support?

Political governance and the compliance with human rights, democratic principles and the rule of law is not only directly linked to the provision of budget support but to any other aid instrument in a given or potential partner country. Thus, the OECD/DAC guidance, which suggests that 'political conditionality should not be specifically linked to budget support or any individual aid instrument' (OECD/DAC 2005) should be maintained. In general, budget support conditionality should be directed towards development objectives based on the national development strategy. Political governance conditionality in budget support operations could even be counterproductive. **The risk is that GBS is used as a donors' tool to impose their governance or human rights understanding which inevitably undermines national ownership.** On the other hand, experiences in many countries have shown that the leverage of budget support dialogue is enormous and regarded as more effective than any other political exchange. In addition, issues of political governance cannot be considered separately from budget support. Donors have to be explicit that they do not tolerate violations of human rights and have to raise these issues in the policy dialogue. However, one must distinguish between minor and severe violations of underlying principles. Minor incidences can be dealt with in GBS operations. In Tanzania, for instance, donors made clear that they do not tolerate increasing violations of media freedom while some donors even withheld parts of their variable tranches. On the other hand, if a country is **severely violating underlying principles it should not be eligible to receive budget support in the first place**. The dealing with underlying principles and political governance should therefore also be discussed within the question of eligibility. The Commission should consider including the respect for underlying principles or the **government's commitment to improve the human rights situation in their eligibility criteria**.

Q2: How can the budget support process be consistent with the political dialogue on underlying principles while maintaining the focus of policy dialogue on agreed development objectives? What could be the relevant fora and the appropriate level involving donors and partner country to raise and discuss concerns regarding underlying principles?

As stated above, the issues of political governance and underlying principles should rather be dealt with in connection with the eligibility of a country. Budget support is not designed to improve the situation with regards to underlying principles in a given partner country but rather to help the country achieve development objectives. The most relevant fora to discuss issues of underlying principles is the consultative process between donors and the government before development cooperation is agreed on or continued. In addition, donors should enter into dialogue with actors outside the government (MPs, civil society organisations, media) and consult with them on underlying principles.

Q3: How can donors meaningfully respond to any deterioration in the underlying principles while protecting the development benefits and predictability of budget support?

Following on from what has been elaborated above, the eligibility of a country has to be reassessed as a first step if underlying principles significantly deteriorate. On the other hand, donors have to be careful to cut budget support if the political stability of a country is in question. In addition, donors have to ensure predictability and cannot suspend GBS operations due to minor incidents of violations of underlying principles (see Tanzania case). There is a certain area of tension between development benefits and the deterioration of underlying principles in all developing countries with a low level of development. With regards to budget support, the following measures can be taken:

- The **use of variable tranches**, as practiced by the Commission, already provides a good tool to react to deterioration in the underlying principles while the overall predictability of budget support is maintained.
- Another option is to give partner governments a **realistic time frame** for taking measures to improve the situation or to suspend or freeze budget support until the situation improves (like recently in Honduras for example).
- Donors can consider **changing from GBS to SBS** to protect public service delivery in sectors such as health and education.
- In the same line, donors can keep up their support to **selected line ministries** to ensure stability and public service delivery.
- If the situation seriously deteriorates, donors should consider providing their assistance through **non-state actors**.

Donor harmonisation is key to remain credible and to achieve maximum impact. All donors should share the same understanding of underlying principles and democracy and use a common approach vis-à-vis the partner government. In many countries, however, some donors cut their budget support operation while others maintain their GBS funding. This leads to a situation in which governments in partner countries face different and sometimes contradictory requirements from different donors which shows a lack of harmonisation.

2 ROLE OF POLICY DIALOGUE, ROLE OF CONDITIONALITY AND LINKS TO PERFORMANCE AND RESULTS

Q4: How can policy dialogue with partner countries be made more effective and inclusive in contributing to achieving reforms, results and objectives?

Budget support has to consider that reforms cannot be 'bought' by donors and that ownership is key to any positive development outcome. The key focus of any budget support operation has to be an intensive and equitable policy dialogue between donors and the government in which the **conditionality is mutually agreed on**. Conditionality, however, cannot replace ownership and donors have to be careful to ensure that **agreed reforms are demand-driven and supported by the government**. Budget support policy dialogue is usually not a one-off meeting, consultations are rather taking place throughout the year agreed to in a calendar of meetings. The most important, however, are the policy dialogue to agree on principles and conditionality of GBS and the annual review to discuss government's performance and results. According to learning assessments in Tanzania and Zambia (Gerster/Mutakyahwa 2006 and Gerster/Chikwekwe 2007), a number of issues can be addressed to improve the quality and inclusiveness of the policy dialogue and annual reviews:

- **Pre-review sessions** of thematic working groups can serve as a forum for
  - The inclusion of stakeholders (local governments, Member of Parliament, civil society, research institutions, private sector representatives) to increase participation and accountability and to enrich the debate with a reality check
  - The opportunity for Ministries, Departments and Agencies to draw the attention of higher authorities to key issues of concern beyond their control
- **Regular follow-up and monitoring of thematic working groups on issues identified in the annual review**, possibly by supporting thematic working groups with competent experts.
- **Alignment of GBS related processes to domestic processes** such as the budget cycle to give domestic stakeholders a better chance of influencing budget guidelines
- **Systematic information of the annual review outcome to other parts of the Government** including a wide dissemination and explanation of the PAF.
- **Improved dialogue between donors and sector ministries** about the benefits of GBS and the need to get MDAs on board.

To improve performance, it is indispensable that the policy dialogue is not only a fora to increase government's accountability to donors. To improve inclusion and transparency of the policy dialogue and the annual review, MPs, civil society representatives and the media should be systematically involved in all partner countries to maximise transparency and to create a platform for improved domestic accountability.

Q5: How should donors use budget support conditionality to help improve performance, and how should they respond to failure to meet agreed conditions?

Most importantly, conditionality should not represent a wish list of the changes donors would like to see in a given partner country. The 2006 evaluation of GBS (IDD and Associates 2006) clearly stated that conditionality cannot impose donor strategies on unwilling governments and that conditionality has to reflect government's and donors priorities alike. In addition, the structural adjustment programmes showed that conditionality can only be effective if partner countries want these reforms. The challenge is to design conditionality **in a way that they are supported by both, partner governments and donors, and that they can actually be implemented by partner governments**. Conditionality should be used in a way to support the management of reforms and should not put political pressure on countries to implement reforms. This can be achieved by adopting medium-term development objectives without identifying the strategies and measures to achieve them (Leiderer 2007). Apart from **ownership**, it is essential that agreed targets are **realistic**.

In general, we have to distinguish between i) policy input, ii) process and iii) result-oriented conditionality. **Policy input conditionality** is aimed at influencing the content of policies in partner countries, mostly used by the World Bank and clearly undermines ownership. **Process conditionalities** are aimed at processes rather than results and are mainly targeted at the reduction of fiduciary risks and the improvement of governance. **Result-oriented indicators** have been pioneered by the Commission and are used for the disbursement of variable tranches and quantitative measurement of poverty-oriented outcomes (mainly in health and education e.g. school enrollment, vaccination coverage). In practice, a mix of political, process and result-oriented conditionality is applied, whereas process and result-oriented conditionality should be preferred by the Commission over policy-input conditionality.1 Result-oriented conditionality is a particularly effective way to use conditionality but involves relatively small sums compared to fixed tranches. In addition, result-oriented indicators need to be improved. A 2008 Eurodad study quotes a government official in Niger saying 'we need the money; therefore we accept performance indicators even if we don't think we will be able to meet them. These negotiations are by their nature unequal as we need the money' (Eurodad 2008: 27). This statement clearly shows that **result-oriented indicators must be realistic and mutually-agreed outcome results**. There are also concerns with regards to the measurement of performance. In Mozambique, for instance, it was found that the PAF arrangement still involves considerable space for the individual judgment of donors (Gerster 2008). Thus, result-oriented indicators should be improved by developing and **using independent measurement of performance**. In addition, result-oriented conditionality is not suitable for every policy area. In some cases, output indicators can lead to a situation in which donors and partner governments focus on technical indicators while losing sight of necessary reforms. Moreover, there are several targeted development results which are strongly dependent on external factors and partner government's responsibility for success or failure is only limited (Leiderer 2007).

If agreed targets are not met, a first step has to be to analyse the underlying reasons

- If it is due **to external shocks** (e.g. the global economic crisis), targets have to be adjusted
- If it is due to **institutional weakness**, donors have to increase their capacity development to address these weaknesses
- If it is due to a **lack of political will**, the disbursement of the variable tranche should be cut accordingly

In general, donors also need to question themselves how realistic those targets were and should not be overly ambitious. It is also very important that ministries are aware of indicators and disbursements that are related to their performance. The key question is, if governments are still on the right track. If so, the policy dialogue should be reopened to identify possible ways forward.

Q6: How can performance monitoring frameworks be improved and result indicators be best used in budget support operations in order to address the challenges identified above?

1This is also confirmed by the European Court of Auditors in its 2009 Annual Report: 'the Court recommends that as regards budget support payments, the efforts made so far to introduce performance indicators that are more oriented towards output and outcome should be continued' (European Court of Auditors 2009: 167) .

The greatest challenge to improve Performance Assessment Frameworks (PAFs) is that in most countries, the focus of the PAF is too wide and reflects a lot of individual preferences of donors. In addition, consensus is often only found at the lowest common level. These factors often lead to **large and conceptually weak PAFs**. These findings have first been raised in 2005 (Lawson, Gerster, Hoole 2005) and still hold true in many country cases (e.g. Burkina Faso, Malawi, Tanzania). A 2008 study of the UK National Audit Office confirms this view and states that 'reviews of performance measurement for strategic partnerships emphasise the need to focus on shared performance goals, with indicators restricted in number to minimise burdens and maximise management freedoms, while maintaining a clear focus on partnership priorities' (NAO 2008: 24). In Malawi, for instance, 29 official PAF indicators translate into a much larger number of actions that the government must take (Eurodad 2008: 21).

Apart from bloated PAFs, **there is a risk that PAFs rather reflect the focus of individual donor headquarters than the partner country context**. According to research findings, development partners fail to agree on a common way to monitor performance and in many cases it is headquarter policies rather than country performance which are the main determinant for aid disbursement. Furthermore, the authors argue that lack of prioritisation between donor triggers confuses the signal donors send to government (Stoelinga and Muco 2008). Thus, **donor harmonisation is key to improve PAFs. PAFs should focus on a limited number of mutually-agreed key issues or reforms**, **aligned with the national poverty reduction strategy and should be limited in their scope**. The coexistence of result-oriented and policy input conditionality in PAFs, on the other hand, risks worsening the cumulative impact on government policy making. As aforementioned, policy input conditionality should be reduced to improve national ownership and performance of partner governments. In addition, the **learning assessments** carried out in 2005 to independently assess the policy dialogue and the effectiveness of PAFs should be resumed and carried out in regular intervals.

Q7: How can the performance of the public financial management system, including fraud prevention measures, and the value for money of budget support funds be best enhanced? Should the EU set minimum requirements for budget support?

Evaluations have shown that the performance of the public financial management (PFM) in many countries has significantly increased through the provision of GBS. However, the studies also indicated that domestic accountability remains the weakest link in PFM and needs increased donor attention (IDD and Associates 2006, Koch and Morazán 2010). To further improve PFM, donors should extent their rather technical understanding of PFM and acknowledge the important complementary role of actors outside the government to improve transparency and accountability of PFM systems.

The second question remains one of the most contested with regards to GBS. **The fact that an effective PFM is precondition and objective of GBS at the same time is a matter of controversy**. The EC and other donors such as the World Bank or DFID use a dynamic approach and argue that no minimum standard for PFM should be applied and that the focus has to be on the reform willingness of the government. Thus, donors balance the risks from weak government systems against the government's commitment to reform and the potential for GBS to help strengthening PFM systems. Other donors, such as Germany, use minimum requirements for PFM and expect countries to have a middle governance level as a precondition to receive GBS. **The key question, however, is how this middle governance level can be achieved in developing countries**. GBS has proved to be one if not the most effective instrument to strengthen PFM in partner countries. Mozambique and Rwanda are two countries, where GBS is rated positively while both would probably not have qualified if minimum capacity criteria had been applied (Hubbard 2008). On the other hand, more research is needed to assess progress with regards to governance and PFM in 'good' and 'bad' performing countries, comparing different aid modalities. In other words, more research should be carried out to identify and compare the effects of GBS on PFM in countries such as Malawi, Nicaragua, Cambodia, Honduras or even in fragile states such as DR Congo or Sierra Leone. If those findings suggest that GBS has a positive effect on PFM and could help countries to achieve middle governance level, it would support the Commission's current procedure not to apply minimum standards.

One must also consider that no minimum standards at all and middle governance level are two extremes. To make any significant use of GBS, **a country has to fulfil basic** standards of governance and of macroeconomic management for GBS to be effective. In this light, Article 61 (2) of the Cotonou Agreement implies that direct budgetary assistance should only be provided if public expenditure management is sufficiently transparent, accountable and effective. The 2005 report of the European Court of Auditors clearly stated that the Commission's dynamic interpretation of this article increases the risk to which European taxpayers' money is exposed and that such an **interpretation requires much more rigorous monitoring of PFM improvements** in the countries in question (EU 2005: 9). Apart from increased monitoring, the EC has to improve its management of fiduciary risks (see Q 14-16) and make their assessments of how to balance fiduciary and other risks against the potential developmental benefits transparent.

In sum, the Commission should:

- extend their technical interpretation of PFM
- undertake research to show that their use of dynamic interpretation of the PFM eligibility criteria does not only work in theory but also in practice
- improve the monitoring of PFM improvements and include measurable targets
- improve fiduciary risk assessment and management
- consider the introduction of minimum requirements to make sure that countries can benefit from GBS and that development benefits are higher than fiduciary risks

3 ACCOUNTABILITY

Q8: How can budget support (including capacity building) be designed to further enhance domestic accountability and ownership in partner countries, including the participation of civil society?

As mentioned above, PFM reform is a key donor focus while domestic accountability often remains the weakest link. To achieve the intended objective to strengthen domestic accountability through the provision of budget support, donors need to acknowledge that PFM can only be effective if domestic accountability is increased, or as put by OECD/DAC Guidelines: 'donors should use the provision of budget support to foster the improvement of partner's PFM systems, including transparency and accountability to their legislature and civil society at large' (OECD/DAC 2006: 27). To achieve this, the EC should:

- Work with a **clear understanding of domestic accountability** in their GBS guidelines that includes actors of horizontal (the checks and balances within a country and key institutions such as Parliament and Supreme Audit institutions) as well as vertical accountability (mechanisms used by citizens and non-state actors to hold government to account)
- Make sure that GBS processes are **as transparent and inclusive as possible.** In this respect:
    - Parliamentarians and civil society actors have to be systematically included in the policy dialogue and annual reviews

- Information flow between donors and parliamentarians needs to be improved by e.g. establishing annual or biannual donor reports to Parliament covering all information and data on budget support or by creating donor-parliament platforms for increased exchange.
- PAFs should mandatorily be send to Parliament
- Budget Support documents and documentation should be widely disseminated to the public and especially the media.
- Civil Society organizations, research organisations and private actors should be consulted and invited to the thematic working groups to contribute their views and expertise.

In addition, more nuanced political analysis is required to assess drivers and constraints to improved domestic accountability and to assess the performance of actors of domestic accountability (e.g. parliament, SAIs, media, civil society organizations and informal aspects of governance). Based on this analysis, **capacity development of key actors of domestic accountability** such as parliament, civil society organisations and the media should be actively supported. The Commission should **better balance budget support funding and support to domestic accountability**. DFID, for instance, is committed to provide an equivalent of up to 5% of all budget support to accountability institutions. Moreover, the EC should develop **holistic and broad-based strategies** to support actors of domestic accountability across **focal sectors** (DFID Act and the Dutch Public Accountability Initiative can serve as good starting points). In this respect, the EC **should actively support mechanisms of social accountability** such as for instance social audits, Public expenditure tracking, participatory budgeting and citizen report cards to increase the extent to which government is held to account. To be effective, donors need **to improve their information sharing and harmonise their interventions**. Compared to other donor approaches, support to domestic accountability is still in its infancy. Therefore, donors need to start focusing on the achieved impacts of support to domestic accountability and start identifying what works and what does not.

Q9: How can mutual accountability better contribute to enhancing effectiveness of budget support operations in both donor and partner countries?

The Paris Declaration points out that mutual accountability has to build on domestic accountability and that first and foremost, donor agencies and partner country governments should be accountable to their constituencies at home.

In addition, the relationship between donors and partner governments are also a crucial element of mutual accountability. An OECD/DAC Issue brief focusing on mutual accountability outlines the efforts both countries need to undertake to improve this relationship: 'partner countries should increase efforts to improve their country systems and policy making, while donors provide more and better aid, align their support with country-owned policies and rely to the extent possible on countries' own systems and national institutions to deliver aid. Accountability on one side is matched by reciprocal obligations on the other' (OECD/DAC 2009: 3). In reality, however, due to the nature of budget support, government's accountability to donors is often much stronger than donor efforts to be accountable to partner governments. A different approach can be found in Mozambique, for instance. In 2004, a Donor PAF has been established to identify areas of improvement for donors and to monitor progress towards increased harmonisation and alignment. In other words, the government and donors now have PAFs with clear indicators and targets. Key lessons learnt are that the strengthening of mutual accountability is a complex process and that donor harmonisation is more difficult than expected (Castel-Branco 2007).

In this respect, donors should consider the introduction of donor PAFs in other country contexts to set themselves ambitious and monitorable targets. However, it is very important that those targets are not only set by donors themselves but informed by partner government's views on what needs to be improved to increase the effectiveness of budget support.

In donor countries, apart from increased transparency and communication of development results (see Q 10) **donors should increase their efforts to subject budget support operations to democratic control.** Whether or not it is justified, development practitioners and MPs of many EU Member States feel that the Commission's procedures and decisions to provide budget support are intransparent and not easily accessible. In Germany, on the other hand, GBS is subject to parliamentary control and has to be approved by the budget committee. To increase accountability on EU level, **it is crucial that the European Development Fund becomes part of the European budget and has to be adopted by Parliament.**

Q10: What kind of visibility/communication activities should be carried out both in donor and partner countries to enhance mutual accountability?

The debate to increase mutual accountability in **partner countries** is directly linked to issues regarding domestic accountability, to which answers have been provided in Q 8. In addition, partner governments should ensure that they are supportive of increased transparency and inclusion of parliament and civil society actors in key budget support processes such as the policy dialogue or annual reviews. In many countries, it is felt that donors have privileged access to information. Both, donors and partner governments are required to publish information on budget support widely to the media and the wider public. **The PAF, for instance, should not be treated as a secret document but mandatorily be distributed to parliamentarians** and representatives of Supreme Audit Institutions (SAIs). Moreover, SAIs should be provided with all information and data concerning budget support without having to ask for it at the Ministry of Finance. Budget support and PFM issues are usually very technical issues and difficult to understand. Therefore, donors should consider supporting governments to publish **popular and easy to understand versions** of audit reports and sector review reports to engage the public in budgetary issues. In addition, channels for civil society organisations to inform the government and donors about fraud and corruption should be actively supported.

Budget support is a complex issue and much contested in many **donor countries**. Overall, general knowledge about the instrument is low. In addition, many fear that budget support exposes taxpayer's money to uncontrollable risks. There is a **huge challenge to disseminate findings of budget support impact** since evaluations of budget support impact on poverty reduction are in its infancy. The 'budget support in practice' series, supported by the Swiss State Secretariat for Economic Affairs is a project that aims to illuminate chances and risks, possibilities and limitations of budget support in a practical manner with a focus on Switzerland's experiences. Case study countries experiences in seven countries (Burkina Faso, Benin, Ghana, Mali, Tanzania, Mozambique, Nicaragua) filled with voices from representatives of the partner country in an anecdotal manner, explain the opportunities and risks of GBS and go beyond the supportive or rejecting view on budget support (www.budget-support.ch). Such publications can help to communicate general knowledge of GBS and make clear that GBS is not simply a blank cheque to corrupt governments.

4 PROGRAMMING OF BUDGET SUPPORT AND ITS COHERENCE WITH OTHER INSTRUMENTS

Q11: What criteria should the Commission use to inform decisions on how much if any budget support to provide to eligible countries?

In general, if countries are eligible to receive budget support, budget support should always be used alongside other instruments. Donors should take into account a number of criteria to decide how much budget support should be provided:

- How high is the **fiscal deficit**?
- What are the main needs of a country and where are the **main deficits**? (governance, health, education, infrastructure). Can those needs be addressed by providing budget support?
- The **performance** of a country. Is the country responsibly managing its finances? How was the performance of a country in the past?
- The degree of **ownership and commitment** by government to the poverty reduction strategy.
- The **absorptive capacity** of a country. Can countries effectively absorb increases of budget support? What are potential constraints to scaling-up budget support? (macroeconomic constraints, institutional and policy constraints, technical and managerial constraints)
- **Fiduciary risks** and risk management. How high are fiduciary risks? Is there an effective fiduciary risk management in place?
- How much **aid** does a country receive? On the positive side: does the aid dependency of a country allow for a meaningful policy dialogue? On the negative side: Is there a risk that increases of budget support may undermine domestic resource mobilization?
- How **harmonised** are donor approaches? Is there a joint assistance strategy in place that strengthens division of labour among donors and reduces transaction costs for the partner country?

Moreover, if a country is

- eligible
- the fiscal deficit insignificant
- problems are rather in other areas (e.g. human rights, oppressive regimes) and cannot be solved by financing the national budget
- No budget support should be provided at all.

Q12: What are the advantages and disadvantages of providing both general and sector budget support within the same country, or having one single budget support instrument? In which context would SBS be considered a more effective type of budget support?

Decisions whether to provide GBS, SBS or other PBAs has to be done on a case-by-case basis and based on experiences made in a given country. In many countries, GBS and SBS coexist without problems. This is confirmed by an ODI/Mokoro study which argues that GBS is best suited to address cross-sectoral issues such as PFM, decentralisation and civil service reforms while SBS can complement GBS by making these cross-cutting reforms more responsive to the needs of sector service delivery. To support public service delivery, SBS and GBS should therefore be used in tandem as the preferred aid modality (ODI/Mokoro 2010). The advantages of having both instruments in place are that the GBS policy dialogue can be used as a platform to address issues arising in specific sectors. Thus, government's focus on particular problems can be increased. In addition, donor sector dialogue with sector ministries is important to ensure that donors do not only exchange issues with few government representatives.

However, it is important that sector approaches are aligned with partner country systems and are not channelled outside the budget. If this is the case, the positive elements of budget support (ownership, use of national systems, accountability) are undermined. In most countries, the use of GBS outweighs SBS (see Table below). A 2008 ODI study found that donors often prefer to create common funds (basket funds) and rely on project aid rather than using SBS and supporting government budgets. The study identifies a number of issues that lead to donor preference of basket funds and project aid over SBS:

- recipient country systems are considered too weak for a shift to budget support
- Parallel funding and management mechanisms generate perks for individuals, including salary top-ups, allowances, vehicles, training and travel opportunities
- The resource flows from a freestanding project or common fund are perceived as more reliable and simpler to manage than funds received via the government budget.
- Donors can be risk-averse. The management of projects can, at least in appearance, be tightly controlled. A switch to budget support, and even just allowing projects to use government procedures, requires a leap of faith that donors are reluctant to take (ODI 2008).

As a consequence, country systems and capacities are rather weakened. SBS, on the other hand, represents a more effective mechanism for strengthening country policies and systems and has the potential to be more effective in improving service delivery than either free-standing projects or Common Basket funds. Thus, according to the study, a mix of modalities preferring GBS and SBS is more effective to prevent the creation of parallel management systems (ODI 2008). In this light, the question should not only be if GBS and SBS can be used alongside but rather focus on the need to increase SBS vis-à-vis other PBAs that are channelled outside government's budgets.

With regards to the second question, SBS could be more effective

- In countries with **low aid dependency and weak policy dialogue**. In the Dominican Republic, for instance, the quality and effectiveness of the policy dialogue is hampered by the fact that GBS makes up a small share of the national budget which limits government's incentives to closely cooperate with donors (Koch and Morazán 2010).
- In countries with **high aid dependency**, low governance performance (potentially issues with underlying principles) but high need in specific social sectors and good performance of respective line ministries.
- Countries which are **not yet eligible for GBS**. The provision of SBS could prepare those countries to receive GBS and could be used as a test-run.

In addition, it is crucial that decisions whether to provide GBS or SBS are informed by consulting EU national offices rather than following headquarter policy to increase GBS.

Disbursement of GBS, SBS and total Official Development Assistance (ODA), 2004 (million USD)

Country	Total GBS	Total SBS	Total ODA	GBS percent of ODA	SBS percent of ODA
Benin	27.1	30.5	200.9	13.5 %	15.2 %
Burkina Faso	75.7	2.1	300.7	25.2 %	0.7 %
Ethiopia	171.1	28.3	543.6	31.5 %	5.2 %
Ghana	128.7	33.2	450.6	28.6 %	7.4 %
Kenya	8.9	0.6	222.7	4.0 %	0.3 %
Madagascar	25.5	-	260.4	9.8 %	-
Malawi	43.0	0.1	330.2	13.0 %	0.0 %
Mali	57.8	8.2	311.4	18.6 %	2.6 %
Mozambique	162.2	51.6	576.5	28.1 %	9.0 %
Niger	33.7	1.9	270.3	12.5 %	0.7 %
Rwanda	46.1	-	185.7	24.8 %	-
Senegal	40.9	6.4	244.2	16.7 %	2.6 %
Sierra Leone	41.0	-	148.8	27.6 %	-
Tanzania	260.9	27.1	1,059.5	24.6 %	2.6 %
Uganda	158.7	53.7	470.7	33.7 %	11.6 %
Zambia	62.9	108.6	572.9	11.0 %	19.0 %
Total	**1344.1**	**352.3**	**6,149.0**	**21.9 %**	**5.7 %**

Source: NORAD, 2006

Q13: What are the advantages and disadvantages, as well as the practical arrangements to ensure consistency and efficient coordination, of using a broad palette of aid instruments alongside GBS/SBS?

In the Paris Declaration, partner countries committed to strengthen their public administration systems while donors pledged to use those systems to the maximum extent possible. In addition, donors agreed that the quality of a country system would determine donor decisions about whether to increasingly use those systems or not. In many countries, however, a large part of aid is still channelled outside the budget. Moreover, the 2008 OECD/DAC ´Survey on Monitoring the Paris Declaration´ found that there is only limited evidence that donors make more use of country systems if they are of sound quality. In addition, project aid is still high on the agenda of some bilateral donors, while some even argue that project aid remains the preferred choice of many donors (ODI 2008).

The disadvantages of using a broad palette of aid instruments alongside budget support is clearly that potential benefits (ownership, accountability, alignment, incentives for reforms) from budget support are undermined (see Q 12). This is confirmed by GBS evaluations (IDD and Associates 2006, Lawson et al. 2005) which found that the continued use of project modalities undermines the potential benefits that can be derived from budget support. The Commission should stick to its commitment to provide at least 66% of its aid in the form of PBAs and should urge other donors to implement the commitments made in the Paris Declaration.

On the other hand, problems in most developing countries are manifold and complex and not all can be addressed by funding the government's budget. In reality, a mix of different aid modalities is applied which can usefully complement each other in support of partner countries poverty reduction efforts. Using multi-level approaches can be advantageous for donors in order to achieve greater synergies in their development cooperation and to address issues at national as well as local level. The use of GBS/SBS alongside other aid instruments can also be complementary. Project aid targeted at institutional development and capacity-building of key PFM institutions (SAIs, Revenue Authorities, Parliament etc.), for example, can increase the effectiveness of GBS/SBS. In addition, to improve the effectiveness of GBS/SBS, actors outside the government such as parliament, civil society organisations, media and research institutions need to be supported to strengthen domestic accountability (see Q 7).

5 STRENGTHENING RISK ASSESSMENT AND DEALING WITH FRAUD AND CORRUPTION

Q14: How can the above risks be best assessed within a comprehensive framework and managed to improve the effectiveness of budget support?

It is striking that in the EC Guidelines neither fiduciary risk nor fiduciary risk management is directly addressed and its management outlined. When it is referred to risks, the Guidelines state that the risks associated with budget support are managed by having conditions attached during the implementation and preparation of budget support. The fiduciary risk assessment of DFID, on the other hand, is very transparent and systematic. Build on DFID's fiduciary risk management a comprehensive framework to assess and manage risks should include:

- A **fiduciary risk assessment** (FRA) prior to starting budget support in order to assess and track changes in fiduciary risk should be mandatory. It is important that a FRA cannot be replaced by the PEFA assessment. Based on the PEFA, donors should develop a FRA to judge the levels of risk associated with the performance of each aspect of the PEFA. Moreover, a FRA should go beyond the technical aspects of PEFA and take into account the historical, governmental and institutional context of a partner country's PFM. In addition, it is crucial that actors outside the executive (parliament, civil society organizations, media, private actors etc.) are consulted to include their assessment and opinion on government's performance and potential risks. A FRA should also rate risks and identify areas where special attention must be drawn.
- A **strategy to mitigate risks.** If budget support is provided, donors have to outline how identified risks can best be managed, focusing especially on areas with high identified risks. In general, three measures should be taken to mitigate risks:
  - short term safeguards and arrangements facilitating the tracking and accounting of expenditures (collaboration with the SAI as well as civil-society mechanisms (e.g. Public Expenditure Tracking, social audits)
  - mechanisms for monitoring key corruption risks and related reforms in

- the medium term
- a comprehensive programme of PFM reforms to address corruption risks in PFM systems (Chene 2010)

Improving public administration and PFM systems is a long-term process. The most effective way to mitigate risks is to support PFM reform as well as domestic accountability systems in order to improve the control environment. Thus seen, any strategy to mitigate risks should not only focus on technical aspects of PFM but also on the need to strengthen actors of domestic accountability (see Q 8).

- Monitoring performance. Fiduciary risks have to be managed on an ongoing basis, at best by making annual fiduciary risk reports mandatory. Are reforms on track? Is there sufficient progress in areas with highest fiduciary risks? What stands in the way for better performance? Are there new fiduciary risks or have circumstances changed? Have donors made enough efforts to address risks? Having measurable outcome indicators in place is crucial. However, these indicators need to be realistic. Many indicators of fiduciary risk management will be informed by the budget support annual review. As with the FRA, donors should consult actors outside the executive to discuss their view on government's performance and progress.

In many countries, donors have made efforts to harmonise their GBS operations, by using the PEFA as the overall framework to assess PFM systems and by using multi-donor PAFs and Joint Assistance Strategies. In this light, **the management and assessment of fiduciary risks should also be harmonised** to prevent parallel structures and burdensome consultations of government and civil society. DFID's approach is considered a good starting point which could be build upon to implement a harmonised assessment and management of risks. A country working group, made up of different donors, in charge of the assessment, consultation of government and actors outside the executive and the monitoring of performance should be considered.

Q15: What kind of measures should the EU apply if the risk level is considered high with regard to fraud and corruption?

In general, one would think that budget support should not be provided at all if corruption levels are high. However, there is only **very limited empirical evidence how corruption levels affect the effectiveness of budget support or how effective budget support** is to tackle corruption. Therefore, more research is needed to assess the interplay of budget support and corruption. A 2010 study found that: 'While corruption has been found to be a serious issue in most countries receiving budget support, there is a broad consensus in the donor community that corruption risks do not outweigh the potential benefits of budget support, as there is no clear evidence that this form of aid is more affected by corruption than other aid modalities' (Chene 2010). Others even argue that budget support increases donor's incentives to deal with corruption and fraud in PFM and that budget support increases the visibility of corruption. Project aid, on the other hand, ignores public administration and builds up parallel systems (Klasen 2009). Other studies argue that high levels of political corruption are the major cause for bad performance of budget support (USaid 2004, Kolstad 2005). Decisions whether to provide budget support to countries where the risk level is considered to be high have to be done on a case-by-case basis. The FRA provides a good tool to identify if corruption risks have improved or even deteriorated. The issue of fungibility of aid can also be best dealt with by having effective fiduciary risk management in place.

In addition, the **willingness of the government to tackle corruption** is crucial for donors to decide whether or not to provide budget support. If donors opt for providing budget support, they should make sure that corruption is an important issue in the policy dialogue and in PAFs and that anti-corruption and accountability institutions (anti-corruption committees, audit institutions, parliament, and civil society) are strengthened through technical assistance and capacity development.

Q16: How can donors meaningfully respond, including with financial corrective measures, to cases of large scale corruption or fraud in the implementation of policies benefiting from budget support?

Overall, research findings suggest that no joint donor response has been explicitly formulated and strategically applied by the donor community on how to react to large scale corruption or fraud. In addition, there is very little evidence of a concerted donor approach to disengagement in corruption-prone environments (Chene 2008). Nevertheless, three main approaches can be identified how donors can meaningfully respond to cases of large scale corruption:

- Suspension of budget support on a **temporary basis** until the country circumstances improve or government takes action (e.g. Tanzania, Malawi)
- Suspension of budget support until **funds were recovered** (e.g. Mozambique)
- Withholding parts of budget support or **variable tranches** (e.g. Tanzania, Uganda)

The case of Tanzania can be used as an example of meaningful donor intervention. In 2007, independent audit reports, commissioned by donors as an accompanying security measure to the budget support operation, revealed the misappropriation of funds (approx. 78 Million Euro) in the Central Bank of Tanzania. As a consequence, all donors suspended budget support and jointly agreed on a number of measures that the government had to take in order to resume budget support flows. Amongst others, donors required comprehensive clarification, legal prosecution, recovering of funds and institutional consequences. Donors met with the government monthly to monitor the progress. The greatest part of the funds has been recovered and key persons, among them the governor of the central bank, were dismissed. Moreover, the parliament of Tanzania took over and demanded investigation into the issue. Due to this credible effort, donors resumed budget support and disbursed funds accordingly. This example shows that donors can meaningfully respond to corruption if they agree on a harmonised approach and most importantly, **if the government is willing to take action**. The case furthermore shows that budget support enables and legitimizes donors to get insights into the financial management system of a country that would not be possible with other aid modalities. Corruption is still a major problem in Tanzania. However, the media, parliament and the wider public is now sensitized and more active due to the disclosure of large corruption scandals.

6 BUDGET SUPPORT IN SITUATIONS OF FRAGILITY

Q17: Should budget support be used to promote stability in fragile states, and if so, how?

Budget support to fragile states is particularly challenging and few bilateral donors are usually engaged. There cannot be a simple 'yes' or 'no' answer to budget support in fragile states, fragile state contexts are too different and specific aid instruments can have a different impact in different contexts. Thus seen, donors should avoid one size fits all proscriptions such as 'budget support is inappropriate in fragile states' or 'civil society organisations are the answer'. Budget support to fragile states can have positive effects. In the early stages of transformation, budget support has been provided with some effect by using innovative methods such as trust funds (East Timor, Afghanistan). Direct budget support to government has been used in more established post-conflict countries with new regimes (e.g. Rwanda, Sierra Leone) and has contributed to stability, restoration of institutions, government ownership and strengthening financial management capacity (OECD, 2010).

Even though decisions have to be made on a case by case basis, a strategic approach to fragile states is needed, which acknowledges that development, politics and security are directly linked and that budget support can have stabilising effects in fragile states. A strategic approach should give attention to

- context analysis,
- prioritisation and sequencing,
- the regional dimensions of insecurity
- more use of political and conflict analysis during programme design.

The OECD/DAC Principles for Good International Engagement in Fragile States may provide guidance in this regard. Any decision whether to provide budget support to fragile states or not has to consider the following:

- **Level of fragility**. There are at least four levels of fragility: (i) post-conflict/crisis or political transition situations; (ii) deteriorating governance environments, (iii) gradual improvement, and; (iv) prolonged crisis or impasse (Leader and Colenso 2005).
- **Political will and reform orientation** of the government to promote macroeconomic stability and poverty reduction. Governments in fragile states, however, often lack a commitment to poverty reduction, and the capacity to implement a Poverty reduction strategy is often limited.
- **Fiduciary risks**. The provision of budget support to fragile states has to outweigh potential stability effects and high fiduciary risks. Trust Funds may provide an option to reduce risk in fragile states. An OECD report notes that "concerns over state legitimation and fiduciary risk will continue to be a strong determinant of the choice and balance of aid instruments in fragile states. For this reason, instruments that limit state control and fiduciary risk – such as humanitarian aid, technical cooperation and projects – will remain key. Minimum conditions for budget support will typically not be fulfilled" (OECD 2010)
- **Extent and degree to which donors can meaningfully cooperate with the government.** There are several instruments that might be best suited dependent on the government capacity and willingness: budget support, ring fencing, public private hybrids (OECD 2008)
- In countries with **political commitment but low capacity**, donors should establish multi-donor trust funds for budget support, invest in large investment projects and security sector reform and provide technical cooperation for capacity-building.
- In countries where there **is little political will** to invest in and account for pro-poor expenditure, programme aid instruments such as budget support will remain inappropriate.

In general, budget support in fragile states has to be accompanied by an overarching strategic framework between government and donors covering political, security and development strategies. In some cases, SBS should be preferred over GBS to isolate and reduce risks:

- SBS can be used in fragile states if overall policy, budgetary and institutional frameworks are considered weak but sector frameworks are viable
- SBS can be used to cover key expenditures for public service delivery (e.g. salaries for teachers and health workers, school textbooks, essential medicines)
- SBS may be used as a pilot and precursor to general budget support (Leader and Colenso 2005)

7 GROWTH, FISCAL POLICY AND MOBILISATION OF DOMESTIC REVENUES

Q18: How can budget support programmes be designed and implemented to best promote inclusive and sustained growth?

Growth is 'pro-poor' if the incomes of poor people grow faster than those of the population as a whole. In other words, income inequality must fall for growth to be pro- poor. Evidence across countries and time periods shows that long-term reduction in income poverty results first and foremost from growth. The pro-poor growth agenda is, by its nature, long term. To promote inclusive and pro-poor growth, EU budget support must be designed to engage with partner countries on a long-term basis and to provide aid predictability. Short-term assistance is unlikely to be productive, unless it complements and is well co-ordinated with more long-term development interventions. The MDG contracts which the Commission launched in 2008 are clearly a step in the right direction. MDG contracts provide countries with a good GBS track of record six-year commitments to ensure greater aid predictability and enable investments and long-term strategies.

To further promote pro-poor growth, the EU should consider the OECD guidelines in their budget support programmes (OECD 2006). Amongst others, the guidelines include the following recommendations:

- Donors should focus on **supporting in-country policy processes**. Donors should support measures to empower the poor in these policy processes and build the country-level capacity to undertake analyses, including poverty impact assessments.
- **A pro-poor lens** on areas important for pro-poor growth, such as i) pro-poor private sector development, ii) pro-poor agriculture, iii) infrastructure and iv) risk and vulnerability, requires a rethinking of donor agendas (ODI 2008)

This implies that donors

- have a good understanding of the political economy of (pro-poor) policy processes
- reorient agendas and approaches to sectors that have a major impact on pro-poor growth
- can draw lessons from ex-ante poverty impact assessments
- provide support that is long-term, predictable, flexible and responsive to country situations (ODI 2008)

For budget support design, this means that **conditionality should build on priorities** agreed on in the poverty reduction strategy paper (PRSP) of a partner country. At the same time, donors should further support **participative and inclusive PRSP processes** to make sure that poor people's priorities are reflected in PRSPs. Implementing policies to promote pro-poor growth involves a continuous process of strengthening the engagement between policy makers and the representatives of the private sector and civil society, especially those who represent the interests of the poor. In addition, donors should promote evidence-based, transparent decision making, as well as innovation and lesson learning to design policies best suited to the local context. In this light, budget support processes should be **as inclusive and transparent as possible** and include close consultations of and collaboration with civil society actors.

Q19: How can budget support policy dialogue and conditionality promote more domestic revenue generation and terminate dependency on aid? What form of an exit strategy should donors include in their budget support operations, and how to arrange it?

The mobilisation of domestic revenue does not only provide more resources but also strengthens domestic accountability. Domestic revenue generation, however, is particularly challenging in many developing countries, especially in sub-Saharan Africa (Morazán 2010). It is therefore unrealistic and too ambitious to talk about the termination of aid dependency in the short and medium term. What partner countries and donors need to do is to focus on a reduction of aid dependency. The budget support policy dialogue should be increasingly used by donors as leverage to support tax reforms and improved domestic revenue generation. **Ideally, the issue of domestic resource mobilisation should be addressed in the policy dialogue and taken up in the policy matrix, flanked by corresponding capacity building measures.**

In some countries, positive experiences have been made. The conditionality of budget support in Ghana, for instance, includes improvements in budget preparation, management of public expenditures and auditing and is accompanied by German technical assistance to improving domestic resource mobilisation (Leiderer 2007). In Tanzania, positive effects have been achieved by supporting the Tanzania Revenue Authority and including domestic resource mobilization in the Poverty Reduction and Growth Strategy. In Mozambique, domestic resource collection increased from 10.8% of the GDP to 16.4 % in 2008. The development of a sustainable financial basis has been increasingly addressed by donors in the policy dialogue, while the fight against corruption in the customs and revenue authority benefited from leverage attributed to budget support (Gerster 2008). Switzerland has been a pioneer in this respect and gives high priority to fiscal policy and tax reforms in all countries where GBS is provided**. In general, however, donors rather focus on the expenditure side and too little on the income side of the budget.**

Including quantitative measurable targets regarding the amount of domestic resources in budget support conditionality should be treated cautiously. Such conditionality could create unwanted negative incentives. Partner governments would be encouraged to focus on taxes which would generate high volumes in the short term but are not necessarily effective with regards to their impact on poverty reduction and economic growth (Leiderer 2007). To improve domestic resource mobilisation, donors should focus primarily on tax reforms, tax policy and tax administration at national and local level and on capacity development of key institutions such as revenue authorities. In addition, in national resource rich countries, initiatives such as EITI should be included in the policy dialogue and in PAFs. In Ghana, for instance, the GBS conditionality addresses the transparent inclusion of oil revenues into the budget and calls for a Petroleum Revenue Management Act and an Extractive Industries Transparency (EITI) Governance Framework (Eberlei 2010).

Q20: How can budget support be used to assist partner countries and regional organisations to further the process of regional integration?

Promoting regional integration is particularly important in Africa. If events go as planned, Africa will soon be home to about 26 different regional trade agreements. These include 14 regional groupings; 5 EPAs; free trade areas between Europe and the north African countries; and South Africa and Southern African Customs Union (SACU) trade agreements with Europe and Mercosur. Even though some progress has been made, major obstacles of intra- and inter- regional trade within regional economic communities prevail. GBS is a mechanism which works mainly at the national level but whose modalities and effects should take account of the commitments for regional integration.

The EU can support partner countries in Africa to further the process of regional integration by addressing the challenges impeding the flow of goods and services within the continent. To do so, the Commission should consider the following prescriptions and strategies that would strengthen Africa's infrastructure development:

- **Deepen regional capital markets** for more regional financial integration.
- **Improve access to long-term financing** by setting up special investment instruments, such as infrastructure bonds, to harness resources for infrastructure investments.
- **Focus on simplifying customs procedures** and harmonising the required information.
- **Customs administrations** in partner countries should cultivate a high level of professionalism and integrity and be more transparent about their procedures and more service oriented. Further, customs administrations should collaborate more with tax departments and other related government agencies (OECD 2010).

A 2010 ECDPM study found that in Africa, the principles of the Paris Declaration are not as well applied at the regional as at national level. According to the study, alignment with regional integration strategies poses serious challenges and further progress is needed in this area. In addition, donors are often better structured and equipped to deal with national partners and sometimes give these priority over regional partners (ECDPM 2010). In general, regional development funds do not yet exist and **funding mechanisms at the regional level pose significant challenges.** Budget support to regional economic communities is not yet a common practice. According to ECDPM, budget support to a region could enhance donor alignment, coordination and harmonisation and lead to increased ownership (ECDPM 2009, 2010). In 2005, the EC was the first donor to give budget support to a regional economic community (COMESA), by establishing the Regional Integration Support Programme and the Regional Integration Support Mechanism. On the other hand, regional economic communities need to fulfill the same eligibility criteria as countries and develop coherent regional development strategies, good governance practices, political leadership and more adequate accountability mechanisms. However, Budget support is designed for national governments and national contexts. If donors consider expanding budget support to supranational contexts, the design and implementation as well as fiduciary risk management would have to be adapted accordingly and carefully thought out.

Moreover, the EC should consider the possibility of more direct support for regional economic communities using aid instruments such as the Development Fund. In addition, the EC should increase their funding for the development of Africa's infrastructure as African governments lack the financial capacities. It is also necessary to further increase support for the Infrastructure Consortium for Africa and the NEPAD Infrastructure Project Preparation Facility (OECD 2010).

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