DAC Task Force on Donor Practices

MOVING TO BUDGET SUPPORT

Prepared for OECD/DAC Task Force on Donor Practices.

The views represent those of the author and not necessarily those of the IMF or IMF policy.

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DONOR FINANCING MOVING TO BUDGET SUPPORT

1. There are encouraging signs of an emerging international consensus on how to best to reduce poverty, based on a growing awareness that developing countries must take responsibility for their own future. The new spirit of ownership and commitment is particularly evident in the initiatives that have been put forward recently by African leaders themselves, such as the Millennium African Renaissance Program (MAP).

2. This has reinforced the need for a reform of the way multilateral and bilateral donors provide development assistance: towards greater support for local ownership and transparency. The traditional ways of giving aid — by tying money to specific projects— is giving way to broader assistance for developing countries’ own strategies and direct support for national budgets.

3. This is based on a belief that a multiplicity of stand-alone projects can weaken a recipient country’s feeling of ownership and undermine the building of local institutional capacity. There is a growing unease with aid and technical assistance programs staffed with overseas nationals and experts, or worse, loans and grant aid tied to donor country exports.

4. Many donors remain unconvinced, however, of the merits of flexible budget support, and argue that such finance gives inadequate reassurance against funds being misused or projects going off-track. Such concerns are borne out by a preliminary assessment by the World Bank and the IMF that found that, despite significant progress in recent years, there is an urgent need for further improvements if public expenditure management systems (PEMs) in HIPCs are to satisfactorily track poverty reducing spending.

5. Perhaps surprisingly, this finding is not inconsistent with, and may even argue for, a move to budget support. Rather it suggests that the challenge is one of capacity building, and ensuring that donor support encourages, rather than hinders, the development of domestic PEM systems. The Bank/Fund review concluded that, with sufficient support from the international community, satisfactory tracking and reporting could be carried out within the next few years, and bridging mechanisms to monitor poverty-reducing spending could be put in place relatively quickly. Budget support can aid this process, and strengthen institution building and budget systems in a number of ways.

Advantages of budget support.

6. Budget support can improve the effectiveness of poverty reduction programs by encouraging ownership and increasing transparency.

**Increased ownership.**

The integration of external assistance into the budget strengthens local ownership by linking aid more closely to local priorities through agreement between donors, civil society, and the government on the overall strategy for poverty reduction. There is a growing realization that “politics matter” and that integrating aid into the budget, which is more closely related to local parliamentary processes, strengthens commitment and accountability.

**Improved efficiency**

Significant efficiency and cost savings can be gained from reduction of duplication of effort and often, unfortunately, competition between donors. A recent review of the PRSP by the ODI pointed to donors “continuing to fuel rent-seeking behaviour by officials and NGOs, thereby further weakening capacity of government to head a strategic process”. Better coordination and pooling of donor support could increase the effectiveness of poverty-reducing spending. Such pooling would allow better intra-sectoral and cross-sectoral allocation of resources according to national priorities.

**Macroeconomic consistency**

7. Failure to embed project and sector approaches in the broader macroeconomic environment can lead to fragmented budgets, a comprehensive breakdown of accountability and poor management of public expenditure. Delayed disbursements linked to complex ex ante procedural or reporting requirements can play havoc with carefully planned budgets. The PSRP handbook notes some of the problems:

- Donors deal directly with line agencies or NGOs and fail to provide the Ministry of Finance with information on disbursements and counterpart commitments.

- Line agencies find it difficult to provide information on external financing due to different donor accounting conventions and payment procedures.

- Line agencies may be unwilling to divulge complete information on aid received since this may result in reduced domestic budget allocations for the sector. For example, the low level of reporting of aid disbursements in Mali remains a chronic problem.

8. More transparent and predictable donor financing would allow for firmer budget and expenditure planning. Moreover, budget support would facilitate evaluating the poverty and social impact of government policies and help prioritize and cost policy measures.

**Macroeconomic sustainability**

9. Poor information on donor projects can inflate sector budgets beyond the level that can be sustained in the long-term. This is well documented in the Bolivia PRSP: “Most of the funding organizations direct their efforts to new investments and technical assistance and do not always consider the possibility of allocating funds for current expenditures, particularly maintenance …fiscal constraints make it difficult to have sufficient resources for national counterparts of such programs and prompts the need to analyze the sustainability of such investments.”
10. Budget support can generate synergies between domestic and donor financing by facilitating spending on recurrent expenditures to maintain and operate infrastructure.

**Strengthened budget management**

11. Budget support has the advantage that it demands that serious attention is paid to the robustness of domestic budget systems and sound financial management. The promise of direct budget support has proved to be a powerful incentive to improve budget management. For example, decentralized financing in the Ghana health sector has led to a considerable strengthening of local budget management centers. The use of government procedures to manage donor funds is already forcing donors and governments to improve and build capacity within the government system, rather than expending effort on parallel project management units. Such units often compete for scarce personnel and may undermine civil service structures.

**Problems and challenges**

12. In practice, there remain several obstacles to donor budget support, and much depends on confidence and the developing countries’ capacities. There are two key problems:

- Donors must have sufficient confidence that funds will be used as agreed and that priorities in the poverty strategies will be adhered to.

- Governments must offer assurances that they will pursue sound financial management and that donors are not “writing a blank check for economic mismanagement”.

13. A move toward budget support has to be assessed with the overall context of economic and social policies, institutional issues, and governance considerations. Where governance and corruption issues are deeply rooted these can only be addressed to a limited extent by development cooperation. For developing countries, improved transparency and adequate control systems are therefore crucial for improving confidence, and gaining broad-based donor support for domestic poverty reduction programs.

14. On the donors’ side, budget support is only one of a range of aid instruments and the choice will depend on a balance of considerations, including the level of the country’s commitment to sound policies, capacity and aid dependence. For example, where commitment to sound policies is unclear, donors may prefer to use NGOs or seek to build commitment through the demonstration effect of projects. Where aid dependence is high, and management capacity strong, the case for reducing transaction costs by direct support for the budget is more compelling.

15. Apart from policy considerations, there are several other factors likely to complicate donor budget support, such as differing terms of financing, donor parliaments’ preference for a particular sector, NGO or project focus, differing financing cycles or disbursement procedures. In many cases, domestic support for development expenditure depends on the ability to point to projects that “show the flag”.

16. For some donors, pooled funding arrangements are not feasible for fiduciary reasons. There are also less compelling reasons. Donors may have strong commercial interests tied to aid or development cooperation agencies dominated by staff with a project background or outlook.
Moving to budget support

17. At the April 2001 meeting of the Bank/Fund Development Committee, ministers stressed the need for all development partners to rely increasingly on the borrower government’s own planning and budgetary process, helping to strengthen these systems where needed. They encouraged the OECD/DAC to help guide and coordinate this work.

18. The Bank and the Fund have taken an important first step with the use of HIPC resources. The Bank-Fund Joint Implementation Committee (JIC) decided that:
   - HIPC resources should not be differentiated from other funds of the recipient country
   - HIPC funds should be tracked, as part of a tracking of overall poverty-reducing spending, through a country’s own public management systems

19. On the part of the bilateral donor agencies the growing interest in budget support stems from growing disillusionment with the traditional “enclave” approach to aid projects. For example, a British Government’s White Paper stated that “where we have confidence in the policies and budgetary allocation process and in the capacity for effective implementation in the partner government, we will consider moving away from supporting specific projects to providing resources more strategically in support of sector-wide approaches or the economy as a whole”.

20. In practice, the initial work of the DAC Working Party on Donor Practices has indicated a pragmatic approach that implies moving through a hierarchy of approaches from better reporting and integration of donor activity into the recipient country’s budget and planning processes, to harmonization of donor procurement, financial management and auditing procedures, and beyond to direct budget support. The process is one of capacity building that requires greater donor cooperation and strong leadership from the aid receiving country. The movement towards general budget support raises two fundamental issues:
   - How funds are used
   - How funds are managed

How funds are used

21. There needs to be sufficient agreement on priorities, and sufficient confidence that they will be adhered to, for donors to give up earmarking for specific uses.

Poverty Reduction Strategies

22. A considerable degree of consensus has been built around the OECD/DAC Poverty Guidelines published in 2001 that promote poverty reduction based on the countries’ own strategy. Although there is no necessary connection between the Poverty Reduction Strategy (PRSP) approach and a particular financing instrument, a key focus is ownership and the integration of donor assistance into the overall budget and planning process. The guidelines recognize that the failure to link policy, planning, and budgeting may be the biggest contributor to poor budget and development outcomes.

Tanzania: MTEF

Donor support for the introduction of an MTEF in Tanzania has improved budget planning:

- **Sharper focus on priorities.** Priority sectors receive priority in monthly exchequer releases.

- **Better decision making.** Additional resources from donors to undertake technical work on budget issues.

- **Improved donor coordination.** Poor integration of donor resources into the budget had led to lack of ownership and limited coherence between public expenditure and donor assistance.

- **Integration of aid into the budget.** An explicit target has been set to increase the amount of donor aid passing through the exchequer system.

- **Capacity building.** Donor concentration on capacity building to manage the budget process better.

**Medium-term expenditure frameworks**

23. In many respects the medium-term expenditure framework (MTEF) has come to be seen as the “panacea” of public expenditure management, and is generally accepted as a necessary step to improve the overall effectiveness of the PRSP process and aid. However, less than a fifth of the HIPCs have a MTEF that is fully integrated into the budget process.

24. The movement to an MTEF involves institutional, technical and cultural change that can place a strain on limited capacities and take a long time (a recent DFID review suggested as long as 5-10 years). Nevertheless, the gap between expenditure implications for policies and budget allocations is so large that even basic support for the principles of an MTEF can help make sector plans more realistic.

**Sector-wide approaches**

25. The development of sector-wide approaches has also been seen as a way in which the government and donor community can agree on common priorities. Unfortunately, lack of consensus on what constitutes a sector program has led to disagreements and not all donors support the process. However, at the core is a sector strategy and recent thinking has emphasized the need to integrate donor funds into the government system rather than using sector approaches to by-pass the budget.

26. In practice, sector programs have been slow to adopt government systems, and SPA tracking records that some 80 percent of donor flows to Africa sector programs still use donor disbursement routes. However, there are cases such as Ghana health where funds are largely disbursed via government systems. The question of macroeconomic consistency was also raised by an SPA review of sector approaches that

pointed to only two countries, Ethiopia and Uganda, that had more than one program that met the criteria of consistency between the sector program and overall macroframework.

**Performance contracts**

27. Under the PRSP approach, there has been increased focus on the reform of conditionality and increasing ownership by the countries concerned. Promoting ownership is seen as one way of ensuring that key policies are fully reflected in expenditure programs on the ground. At the same time, there is recognition that top down planning and highly centralized budget systems can be inflexible and poorly adapted to the implementation of poverty programs.

28. One mechanism that has gained attention is the “performance contract” that gives more autonomy to decentralized budget agencies but sets standards and targets that the budget holders have to achieve. This system has been used extensively in public sector management reform in New Zealand, and has been adapted for use in Ghana and Tanzania.

**How funds are managed**

29. There needs to be confidence in how funds are managed if government procedures are to be used rather than simply using common donor procedures. Donors have therefore become more concerned with the overall improvement of financial management systems. The IFIs have developed a number of assessment tools, checklists and guidelines to assist in evaluating public expenditure management (PEM) systems. Initial attempts include the development of “benchmarks” for assessing the budget by the IMF and the World Bank. Financial assessments include the World Bank’s Country Financial Accountability Assessments (CFAAs), and the UN Programme for Accountability and Transparency (PACT).

**PEM Benchmarks**

30. The IMF/World Bank have developed “benchmarks” to describe the basic requirements for a PEM system to track poverty-reducing public spending. Basic standards are applied on budget formulation, execution and reporting. These differ from the IMF Code on Fiscal Transparency that focuses on the “transparency” of institutional arrangements rather than the performance of specific tasks. The benchmarks are fairly comprehensive covering the formulation, execution and reporting of the budget. An initial survey suggested that nearly all the HIPC countries require significant technical assistance to upgrade their systems and help build PEM capacity. The weakness of the initial findings suggest that the program of technical assistance will have to be substantially augmented. The proposal for a multi-donor Trust Fund can help in this regard.

Transitional arrangements

32. These results suggest that “bridging” arrangements are needed to track poverty reducing spending that are consistent with the goal of strengthening local PEM capacity. Some preliminary approaches include poverty funds, hurdle criteria and harmonization of donor procedures to support the development of domestic budget processes.

Poverty funds

33. A number of countries have adopted institutional poverty funds to monitor assistance as a short-run measure. While this has been inevitable in some cases, the IFIs have advised against such an approach. The diversion of limited skills and capacity to create the funds can aggravate the problems of transparency of the budget as a whole. Also, if the amount of resources channeled through the funds only represents a small part of government social spending, and resources are fungible, it will be difficult to assess the overall impact on poverty reduction. It can also increase overlapping expenditures and make resource allocation less flexible.

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<table>
<thead>
<tr>
<th>HIPC Countries Requiring Upgrading</th>
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<tbody>
<tr>
<td>Little</td>
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<tr>
<td>Some</td>
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<tr>
<td>Substantial</td>
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“Virtual” poverty funds

34. A preferable arrangement is to use “virtual” poverty funds which tag budget line items related to poverty reduction, which are then monitored as part of overall budget execution. In using budget procedures, this system avoids the pitfalls of a separate institutional mechanism. For example, in Uganda the Poverty Action Fund identifies poverty reducing programs at the level of budgetary line items. Similar systems are being adopted in Tanzania and Guyana. However, such “tagging” systems already assume a fairly efficient system of budget classification and expenditure tracking.
“Hurdle” criteria

35. A number of countries (e.g. Uganda, Ghana and Thailand) and aid agencies (UNCDF) are experimenting with hurdle criteria (particularly in financial management and accountability mechanisms) before responsibilities and resources are devolved. These budget management criteria are often linked to performance contracts. For example, in the Ghana health sector only those Budget Management Centres (BMCs), which meet certain “readiness” criteria, were allowed to manage their own funds.

<table>
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<tr>
<th>Summary PEM Benchmarks</th>
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<tbody>
<tr>
<td>● Comprehensiveness</td>
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<tr>
<td>- Covers general government</td>
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<tr>
<td>- Off-budget expenditure minimal</td>
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<tr>
<td>- Outturn close to budget</td>
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<tr>
<td>- Donor funded spending covered</td>
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<tr>
<td>● Classification</td>
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<tr>
<td>- Functional and program information included</td>
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<tr>
<td>- Identified use of classification system</td>
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<tr>
<td>● Projections</td>
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<tr>
<td>- Projections integrated in budget</td>
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<tr>
<td>● Internal control</td>
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<tr>
<td>- Low arrears</td>
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<tr>
<td>- Internal audit function</td>
</tr>
<tr>
<td>- Regular use of tracking surveys</td>
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<tr>
<td>- Reconciliation of monetary and fiscal data routine</td>
</tr>
<tr>
<td>● Reporting</td>
</tr>
<tr>
<td>- Monthly reports within 4 weeks</td>
</tr>
<tr>
<td>- Timely functional reporting</td>
</tr>
<tr>
<td>- Auditing of accounts</td>
</tr>
<tr>
<td>- Accounts closed within 2 months of year end</td>
</tr>
<tr>
<td>- Audited accounts presented to legislature within one year.</td>
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Those who fell short received training and support to improve performance. The result is that the vast majority of BMCs now meet the criteria.

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<th>Hurdle Criteria Tanzania</th>
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<tr>
<td>● Seven donors have been pooling funds since 1999, initially to support 35 health centres.</td>
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<td>● The Ministry of Health requests the joint government-donor committee to release funds costed in a plan of action.</td>
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<tr>
<td>● A steering Committee receives district health plans and approves release of funds on a quarterly basis against approved district plans and budgets based on “Readiness Criteria”:</td>
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<tr>
<td>- Approved district health plan and budget</td>
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<tr>
<td>- Positive assessment of technical and managerial capacity</td>
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<tr>
<td>- Satisfactory and timely reports</td>
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<tr>
<td>- An annual independent audit is carried out resulting in a management letter assessing controls and systems</td>
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A recent ODI review\(^5\) points to a number of lessons from these experiences:

- It is feasible to provide adequate accounting even in fairly weak and decentralized systems.
- Significant efficiency savings are possible.
- Donors should stand back from direct involvement in the details of the system.
- It is important to minimize reporting and within year conditions to avoid problems of maintaining disbursements.

**Harmonization**

36. The DAC Working Group on Donor Practices is looking at “best practices” for supporting poverty reduction and integrating donor activities into the budget and planning framework. This includes the harmonization of their own processes including common disbursement, accounting, reporting and appraisal systems. This work should aim at allowing resources to be channeled increasingly through government systems and at enhancing the transparency and predictability of donor financing. Increasing the reliability of donor disbursements in both timing and amount should greatly improve budgeting and planning.

**Conclusions**

37. Support for local ownership under the PRSP is forcing multilateral and bilateral donor agencies to look at new and innovative forms of conditionality and financing that provide support for, rather than erode, the building of local institutional capacity. Much will depend on individual country cases. But budget support by focusing on government priorities and institution building can go a long way to help coordinate international support for country-led poverty reduction programs. Greater coordination between multilateral and bilateral creditors is required to harmonize donor procedures, and to meet countries’ demands for capacity building. One initiative being discussed by the EU and the World Bank is the possibility of a special Trust Fund to fund assessments, define realistic benchmarks and hurdle criteria, and support capacity building in public expenditure management. Several bilateral donors have indicated a willingness to be involved in this work as well as considering ways how programme aid can be used more imaginatively to test and improve government accounting and management procedures.

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5. Foster, M a, 2000, “The Status of Sector-Wide Approaches, ODI Centre for Aid and Public Expenditure”.