

3. How can the risks of General Budget Support be managed?



The Joint Evaluation of General Budget Support 1994–2004: Thematic Briefing Papers

In 2004 a group of 24 aid agencies and 7 partner governments commissioned a joint evaluation of General Budget Support (GBS). Its purpose was:

to assess to what extent and under what circumstances GBS is relevant, efficient and effective for achieving sustainable impacts on poverty reduction and growth.

This independent study was led by the International Development Department of the University of Birmingham. Its outputs are seven country case studies – for Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Uganda, and Vietnam – and a Synthesis Report.

This Briefing Paper describes the evaluation’s findings on the risks associated with GBS and highlights its recommendations on how they should be dealt with.

What was evaluated?

Partnership General Budget Support

General Budget Support (GBS) is aid funding to government that is not earmarked to specific projects or expenditure items. It is disbursed through the government’s own financial management system. The finance is accompanied by other “inputs”: conditions and procedures for dialogue; donor efforts to harmonise their aid and align it with national policies and procedures; and technical assistance and capacity building.

In the late 1990s “new GBS” or “partnership GBS” (PGBS) emerged as a response to dissatisfaction with earlier aid instruments. “Partnership” is contrasted with the imposed conditionality of the structural adjustment era. PGBS is intended to support partner countries’ poverty reduction strategies.

The study countries

The study countries were an illustrative, not a representative, sample. Nevertheless, as Box 1 shows, the variety of contexts gave opportunities to draw lessons from contrasts as well as similarities between countries. However, the short history of PGBS limits the scope for robust findings at outcome and impact level.

Risks: what are the issues?

Partnership General Budget Support (PGBS) was rooted in dissatisfaction with existing aid instruments. This implied a willingness to take some risks on a new approach. However, it is in all stakeholders’ interest to understand and to mitigate such risks.

It is always relevant to consider:

- Who is affected by risk? (donors, governments and government agencies, citizens?)
- Does the risk apply specifically to budget support or to aid in general?
- What is the scale of risk, relative to the potential benefits of PGBS?

This paper discusses the potential risks to PGBS under four main headings:

- Macroeconomic risks

- Fiduciary risks
- Corruption
- Political risks.

HIV/AIDS represents an additional cross-cutting risk – see Box 2.

What are the macroeconomic risks?

Unpredictability of disbursement

Why predictability matters

Budget predictability is important to make the budget process credible and to allow efficient use of funds. Predictability of aid matters more when aid is a large portion of public resources. Predictability and volatility are not quite the same thing.

According to OECD DAC criteria¹:

- Aid is *unpredictable* when partner countries cannot be confident about

Thematic Briefing Papers

The full series of thematic briefing papers is:

- 1: What are the effects of General Budget Support?
- 2: When and how should General Budget Support be used?
- 3: How can the risks of General Budget Support be managed?
- 4: How does General Budget Support affect ownership and accountability?
- 5: GBS – Policy Questions and Answers
- 6: GBS – General Questions and Answers

Briefing Papers on the Synthesis Report and each of the country studies are also available.

¹ *Harmonising Donor Practices for Effective Aid Delivery. Volume 2: Budget Support, Sector Wide Approaches and Capacity Development in Public Financial Management.* OECD DAC, 2005.

Box 1: Country Contexts and PGBS Flows

	Country Context					PGBS				
	Size	Aid Dependency		Government Capacity		Duration		PGBS "volume"		Donor Involvement
	Population (millions) in 2000	GNI per capita (USD) in 2000	ODA as % GNI in 2000	CPIA Quintile in 2003	CPIA change from 1999 to 2003	Starting year for PGBS	Flows up to 2004 (million USD)	PGBS as a share of ODA in 2004	PGBS per capita (USD, cumulative)	No. donors providing PGBS in 2004
Burkina Faso	11.3	250	12.9	2	+1	2001	500	25%	44.3	7
Malawi	10.3	170	26.1	3	-1	2000	148	5%	14.4	3
Mozambique	17.7	210	25.4	3	-1	2000	611	19%	34.5	15
Nicaragua	5.1	740	15.0	1	+1	2002	77	4%	15.1	3
Rwanda	7.7	260	17.9	3	0	2000	248	26%	32.2	4
Uganda	23.3	270	14.3	1	0	1998	1,775	31%	76.2	16
Vietnam	78.5	380	5.5	1	+2	2001	570	8%	7.3	9

Source: Synthesis Report, Tables 3.1-3.5 and Figure 3.1

Notes: The World Bank's Country Policy and Institutional Assessment (CPIA) tool assesses each IDA Country's present policy and institutional framework for fostering poverty reduction, sustainable growth and ability to use development assistance effectively.

the amounts and the timing of aid disbursements.

- Aid is *volatile* when fluctuations in aid flows are large, relative to the volume involved.

Budget support aims to reduce the unpredictability of aid. But, precisely because it directly supports the budget, there are immediate consequences if anticipated PGBS funds do not arrive. There may be

macroeconomic effects because of the amounts involved and because of knock-on effects on domestic borrowing and interest rates.

Short-term predictability

Early problems with the short-term predictability of disbursements made it difficult for governments to integrate PGBS funds in budget planning. If the funds did not arrive when they were anticipated,

governments had to choose between underspending on budget commitments or increasing short-term borrowing. Apart from its fiscal costs, borrowing sometimes had undesirable macroeconomic effects through driving up domestic interest rates.

Measures to make PGBS less vulnerable to short-term unpredictability have included agreements to base disbursements on previous rather than current-year performance and to avoid in-year cuts in all but very exceptional circumstances. In addition to this, PGBS arrangements have become increasingly aligned with the recipient governments' budget calendars. In some instances partner governments have used reserves to buffer fluctuations in aid receipts. (Actual disbursements of PGBS (as of other aid) commonly fall short of donors' predictions. To allow for this, Uganda has applied a systematic discount to donor projections.)

Overall the steps taken by donors have improved short-term predictability of PGBS funds, though other sources of short-term risk remain.

Medium and long-term predictability

There have also been efforts to extend the planning horizon for PGBS. For example the majority of PGBS donors in Mozambique now give indications of budget support intentions over a three-year horizon. However, there is still a contrast between the long-term objectives of PGBS (notably its role in financing progress towards the MDGs) and the predominantly short-term funding

Box 2: Assessing the long-term impact of HIV/AIDS

HIV/AIDS is a significant long-term risk. In the majority of the case study countries, HIV/AIDS is already having large-scale demographic, social and economic effects. These are poorly understood and need to be explored in detail in each case.

A so-called "chimney effect" on population has been predicted for Botswana and was already seen in census data from parts of Uganda as early as 1993. This occurs when the very young and the very old are supported by only a slim pillar of remaining people in their prime of life. There is a danger that this scenario may be generalised to all countries. To do so would be inappropriate and a poor basis for policy making. Country-specific AIDS impact modelling is recommended.

When an epidemic reaches more than 1% HIV prevalence in the general population it is serious but potentially manageable; when it exceeds 5% it is probably out of hand and will have social and economic impacts affecting growth and development. Of the seven country case studies examined for this evaluation Mozambique, Uganda, Malawi and Rwanda have adult prevalence exceeding 5%; in Burkina Faso it is around 5%. In both Nicaragua and Vietnam, general adult prevalence remains very low, but it is elevated in some groups and geographical areas.

In all of these countries, HIV poses serious long-term implications for development strategy and for public expenditures (e.g. for prevention and treatment, for resource availability, for demands on public expenditure, for the attrition of skilled personnel). These long-term issues have been seriously neglected. The dialogue around PGBS can be useful in addressing cross-cutting issues such as HIV/AIDS.

Source: Synthesis Report. ¶15.102 (which provides bibliographical references).

Box 3: Possible long-term budget support instruments

In line with commitments to the MDGs and the scaling up of aid, aid agencies should work with governments to develop genuinely long-term budget support instruments that could provide reliable support, where appropriate, to the recurrent as well as capital budgets of partner countries, over time scales that match partner countries' medium and long-term expenditure plans. Design of such instruments should build on lessons from the HIPC debt relief initiative and from PGBS.

Thus, disbursement would be through government systems, with due process conditions on transparency of budgets and expenditure records. In order to reinforce political support and to express the intentions of the funding, notional earmarking may be appropriate, most probably linked to sectors such as health and education where needs are high and political support is strong. Thus, budget support funds would be linked to monitorable government undertakings about levels of total funding to the sector, to an agreed medium and long-term expenditure plan for the sector (allowing for diminishing dependence on aid over the longer term), and to sector-wide mechanisms for dialogue and complementary technical support. To reinforce the reliability of donor funding, it could be channelled through a trust fund managed by a multilateral agency.

commitments by donors. The evaluation recommended developing genuinely long-term budget support instruments (see Box 3).

Risks in common conditionality

Volatility in budget support may arise from the way that conditionality operates. The risk of volatility is greater if donors' budget support decisions are completely harmonised. Particular risks arise when donors link their disbursement decisions to the IMF's macroeconomic conditions, and when donor decision-making makes changes in budget support disbursements both large and abrupt.

Macroeconomic conditionality

PGBS donors have generally left macroeconomic dialogue to the leadership of the IMF, with staying "on track" with the IMF as a condition for disbursements. This creates two risks for the partner country:

- First, even a technical breach, or a bureaucratic delay, in the IMF's formal endorsement, may cause the disbursement of PGBS to be delayed.
- Second, if aid is reassigned from a project modality to budget support, the recipient's vulnerability is increased. Budget support becomes hostage to IMF on-track status, although continued disbursement of project aid for the

same purposes would not have been affected in the short term.

To mitigate the first problem, the link between PGBS instruments and IMF on-track status should be less mechanical. The IMF now distinguishes its signalling role from its own financial facility. Instead of automatically echoing the IMF response when its conditions are breached, other donors should decide separately, taking account of IMF advice, whether the situation justifies a suspension or tapering off of their funding.

In making such decisions, donors should take account of the second problem. If, for example, PGBS is part of a deliberate strategy to support the government's recurrent budget over an extended period, funds should be guaranteed except in an extreme situation (cf. Box 3 above and Box 5 below).

Graduated responses

The need for graduated ("proportionate") responses is being addressed in various ways. Recent MOUs are more transparent about how funding and disbursement decisions will be made, and have strengthened procedures for dialogue about disbursements. This leaves less room for partners to surprise each other (and publishing information about government performance is

itself a form of graduated response). Donors increasingly draw on a common set of performance indicators to inform their funding decisions, but still take their decisions separately; this reduces the risk of exaggerated volatility. Some donors have linked part of their disbursements to a subset of performance indicators. (However, the evaluation concluded that it would be undesirable for the bulk of annual PGBS disbursements to be linked in any mechanical way to outcome indicators – see the discussion of performance monitoring in Thematic Briefing Paper 2.) The operation of parallel "sector" and "general" budget support instruments also facilitates graduated responses.

Undermining revenue effort

The study found no evidence of reduced revenue effort in response to PGBS flows. It is still possible that an assured flow of PGBS, other things equal, could lead to a reduction in revenue effort over the long term. But in practice, PGBS is accompanied by direct measures to strengthen revenue institutions in the assisted countries, and revenue performance is included among the performance indicators monitored.

Absorptive capacity and aid dependency

Concerns about absorptive capacity and aid dependency are often linked to a critique of poverty reduction strategies that are seen as too heavily reliant on the expansion of public services.

At a specific level, expanding public expenditures may be inefficient if supply bottlenecks (e.g. training of teachers) are not addressed. The evaluation recommended that more attention should be paid to such issues in future.

In aggregate, there are fears that large volumes of budget support could induce "Dutch disease" – where exchange rate appreciation and heightened demand for non-tradables undermine private sector growth. The evaluation did not find such effects. Moreover, the issue is not specific to budget support: it is a potential consequence of total aid flows.

A similar point applies to the question

of aid dependency, and what levels of aid flow are desirable or sustainable. Dialogue on such matters should be about aid as a whole, not limited to a particular modality. Partner countries need to develop aid strategies which explicitly address long-term aid dependency and absorptive capacity.

What are the fiduciary risks for PGBS?

Aid and fiduciary risks

Fiduciary risks are the risks that public resources:

- are not used for the intended purpose;
- are not properly accounted for; and/or
- do not provide value for money.

Corruption (discussed separately below) is one of the sources of fiduciary risk.

Donors are not the only stakeholders who are vulnerable to fiduciary risk: the partner country's citizens, not least the poor, are the primary victims.

Budget support (among other forms of aid) is vulnerable to weaknesses in public finance management (PFM) systems. At the same time, the ways in which aid is delivered may strengthen or weaken those systems.

Safeguards for donor funds have often involved special implementation arrangements that bypass mainstream government systems. However, the fiduciary comfort derived from separate controls and "ring-fencing" of aid funds has limits. Earmarking of funds is not a guarantee against fungibility; separate controls do not address (and may worsen) the underlying weaknesses of PFM; and the costs of complying with such safeguards may reduce the value for money of aid.

Fiduciary safeguards for PGBS

Funds provided through GBS are subject to a variety of safeguards:

- Diagnostics of partner country financial management systems have been used to assess and monitor levels of risk. In practice, donors have not applied standard benchmarks of performance across countries. They have given weight

to the credibility of governments' commitment to strengthen PFM. Donors increasingly collaborate in such diagnostics; the recent approval of a standard performance assessment system² is taking this further.

- PGBS itself is used to strengthen PFM. The evaluation found positive effects on PFM where PGBS was established. The effects of passing more funds through government systems are enhanced by complementary capacity development efforts and by the agreed performance conditions attached to PGBS.
- Although PGBS is not earmarked, the strategies it supports and the conditions attached to it do have implications for the level and pattern of public expenditures. PGBS dialogue and performance reports relate to public expenditures as a whole, and PGBS donors can thus gauge the influence of their funding on public expenditure as a whole.
- PGBS has supported greater transparency in public expenditures and higher standards of accounting and reporting. In some cases,

notional earmarking has been used to draw attention to the role of PGBS in enabling the government to fund certain components of expenditure. The safeguards applied to PGBS funding tend to strengthen the fiduciary environment for all forms of aid.

How does corruption affect PGBS?

Significance of corruption

PGBS requires a basic level of trust between partners. Corruption – especially high-level corruption – undermines this. Corruption also corrodes public support for aid in donor countries.

Corruption is inherently difficult to measure. Standard indexes of corruption are based on perceptions, and are not a reliable guide to trends. Increased visibility of corruption may reflect a worsening situation or improvements in transparency. It is important to understand the drivers of corruption, one of which may be political competition.

Corruption can affect all modalities

Box 4: Donor experiences in combating corruption

A recent synthesis of donor experiences in combating corruption highlights the following lessons:

- There are no quick fixes, but a need for long-term comprehensive approaches that aim at systemic change.
- There are a variety of entry points for addressing corruption. Explicitly fighting corruption does not have to be the main point of entry: significant work, frequently not identified as anti-corruption, is being done to make improvements to financial systems, procurement, oversight agencies, etc. in the name of efficiency, transparency, capacity building and institutional strengthening.

A clear understanding of the political economy of corruption is a necessary basis for effective action against it. Experience and specific knowledge of the country context is essential.

Policy dialogue, if it is based on sound country knowledge, can play a useful role in combination with other instruments, especially in supporting partner country leadership that is committed to change.

Source: Final Report of the OECD Development Assistance Committee Development Partnership Forum on Improving Donor Effectiveness in Combating Corruption, 9–10 December 2004. (OECD, February 24, 2005.)

² Public Financial Management: Performance Measurement Framework. PEFA Secretariat, World Bank, June 2005.

of aid, sometimes in subtle ways (e.g. corruption creates a bias towards capital expenditures, because investment projects offer more opportunities for illicit gain). Aid modalities themselves affect the environment for corruption (e.g. a multiplicity of donor procedures outside of government systems may complicate and undermine the role of national audit institutions; tied aid may create a non-competitive contracting environment). Box 4 highlights lessons of donor experience in combating corruption.

Corruption and PGBS: the evaluation's findings

Corruption is perceived as a serious issue in all the study countries but available data, being based on perceptions, are not robust enough to indicate reliable trends in performance.

- Corruption is singled out as a source of tension and difficulty between partners in almost every case.
- Corruption and anti-corruption measures have featured explicitly in the performance matrices and conditions linked to PGBS. Such conditions mainly relate to legal measures, policy development and administrative actions (such as implementing leadership codes). Even when formally complied with, they have not been conspicuously effective.
- Work on public finance management has had a more significant practical effect on the environment for corruption.
- PGBS donors have also pursued anti-corruption strategies by complementary means, including specific projects and TA to support accountability institutions (audit agencies, parliaments etc), and support to civil society organisations.
- There was no clear evidence that budget support funds were, in practice, more affected by corruption than other forms of aid.
- More (shared) research is needed on corruption. Political analysis should encompass work on the drivers of corruption, and there should be more practical investigation of how corruption

affects the poor (e.g. in service delivery).

What do political risks imply for the durability of PGBS?

Political risks to GBS are those that arise less from the technical aspects of performance than from the underlying political relationship between partners. All donors, but especially bilateral agencies, premise official aid to governments on basic principles about standards of governance and human rights. These principles have become more visible in the MOUs that underlie collective budget support arrangements, as well as in the bilateral understandings between individual donors and partner governments.

There were strong political motives for PGBS in several of the study countries (e.g. to support the reforming policies of a new regime). However, political risks were not well factored in to the design of budget support. In several countries, the political risks of PGBS were underestimated, and assumptions about donors' ability to influence the partner country's political system were unrealistic.

The DAC good practice guidelines (op. cit.) advise that *political conditionality should not be specifically linked to budget support*

or any individual aid instrument, but rather should be handled in the context of the overarching policy dialogue between a partner country and its donors. Nevertheless, experience shows general budget support is especially vulnerable when there is a deterioration in political relations.

This undermines PGBS as a long-term instrument. Apart from immediate disruptive effects, it makes partner governments less likely to treat PGBS as a reliable source of financing for medium and long-term planning, and this in turn may undermine some of the distinctive benefits of PGBS.

Political risks cannot be eliminated, but PGBS could be made less vulnerable by:

- more systematic analysis of political contexts, which would help to set realistic objectives and expectations for PGBS;
- clarification (e.g. in MOUs and bilateral agreements) of underlying political conditions for PGBS, and of procedures to be followed when fundamental difficulties emerge;
- more attention to the design of PGBS instruments, so as to make them a less obvious target when donor governments seek to send political signals (see Box 5). The design of budget support instruments should seek to increase

Box 5: How design affects the political vulnerability of budget support

The evaluation noted that re-balancing an aid portfolio from projects towards budget support potentially increases the amount of aid that is hostage to macroeconomic conditionality. A similar point applies to political risk. A tranche of budget support that is subject to a single, annual decision, requiring positive approval by a donor minister, is especially vulnerable to demands for public signalling.

Conversely, there is less of a "hair-trigger" involved if funds are identified in the donor public's mind with specific (popular) sectors, if there are longer intervals between decisions, if funds are disbursed via a third party, if there is a joint agreement with other partners, etc. There are precedents, too, for politicians deliberately insulating themselves from day-to-day disbursement decisions (delegation of monetary policy to central banks is a famous example; independent boards are commonly appointed to distribute various grants). And aid agencies which make a point of assessing likely poverty impact before commencing funding should be equally assiduous in transparently assessing the poverty impact of suspending funding.

the options for graduated responses when political signalling is deemed necessary;

- raising the level of public debate about aid and how it works.

How can risks be spread?

The evaluation recommended that:

Decisions about the adoption (and the design) of budget support should be based on a country-level assessment of the balance of potential risks and benefits.

In making this assessment, donors

and partner governments need to consider aid portfolios as a whole. Few risks are unique to a particular modality, and different instruments can be used in combination to mitigate risk. For example, PGBS can play a valuable long term role in strengthening PFM and reducing general levels of fiduciary risk, while anti-corruption strategies can also be supported by targeted assistance to government and non-government agencies.

The study proposes an incremental approach to PGBS, in which risk

assessment would be an important factor (see Thematic Briefing Paper 2, When and how should General Budget Support be used?).

What are the evaluation's recommendations?

The evaluation's Synthesis Report made a series of recommendations. These are all included in the Synthesis Report Briefing Paper. The box below highlights the recommendations that relate directly to the themes of the present paper.

Box 6: Recommendations for managing risks in General Budget Support

On managing risks:

- Retain the IMF role in monitoring, reporting and advising on macro-economic performance, but do not link all PGBS funds to the IMF's own conditions.
- Accompany PGBS with support to revenue collection.
- Assess fiduciary risks from the perspectives of all stakeholders, not just donors.
- Support common approaches to diagnosis and monitoring of PFM standards.
- Decisions about the adoption (and the design) of budget support should be based on a country-level assessment of the balance of potential risks and benefits.
- Strengthen (shared) analysis of corruption and the way it affects the poor.
- Exploit the potential for budget support to help strengthen public finance management and limit corruption.
- Undertake more systematic analysis of political risk in relation to budget support.
- The design of budget support instruments should seek to increase the options for graduated responses when political signalling is deemed necessary.

On managing aid:

- Develop aid strategies to optimise complementarity between aid instruments, including budget support, at country and sector level.
- Develop genuinely long-term budget support instruments.

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