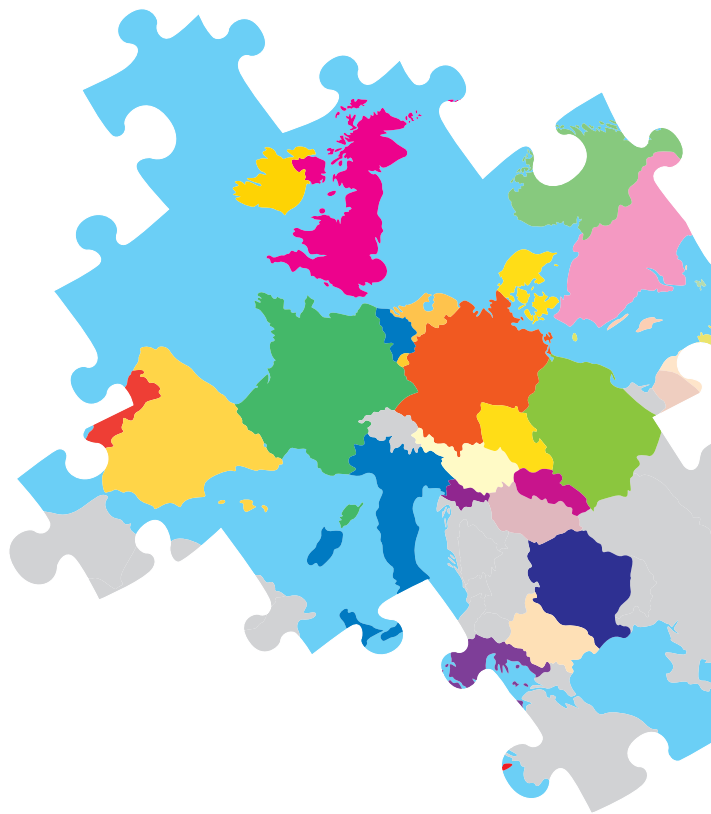


# The future of EU budget support: political conditions, differentiation and coordination

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**A**t the end of 2011 the European Commission<sup>1</sup> published a Communication on the future of EU budget support. This Communication introduces important changes, particularly for the EC as a budget support provider. The new Communication obliges the EC to open up its budget support approach to promote, democracy and human rights, alongside the goal of reducing poverty.

It is perhaps no accident that this policy change comes at a time of increasing criticism by member states of the EC's previous budget support strategy.

While the EC can no longer afford to be ambivalent to democratic governance conditions in recipient countries, tying budget support more strictly to political conditions poses a number of significant challenges.

Four interrelated messages have emerged from our analysis:

1. Accounting for the prevailing political conditions in recipient countries in different

ways in different budget support operations makes little sense from a purely technical perspective. Yet from a political perspective such an approach is likely to shield the EC from domestic criticism.

2. Currently no clear strategy exists on how budget support can be used to leverage political change and promote democratic governance. There is also ambiguity surrounding criteria for determining if a recipient country can receive budget support.
3. If rigid selectivity is pursued the EC faces the challenge of safeguarding its leverage and scope for action, forcing it more closely to the position of the '28th European donor'.
4. In certain contexts donors can leverage changes in democratic governance, provided they drastically improve on coordination to produce coherent incentives for the recipient government and employ a credible set of sanctions in case of non-compliance. Yet donors do not have a strong track record in doing either of these.

While appetite for budget support has notably declined amongst bilateral donors, it remains the EC's preferred aid modality according to its own claims.

However, a commitment to democratic governance and human rights was previously not a prominent feature of EC budget support which instead focused mainly on technocratic governance reforms in recipient countries. This led to several member states considering the EC's use of General Budget Support (GBS) too lax and too insensitive of political issues. The Arab Spring and the fact that the EC had provided budget support to authoritarian and repressive regimes in the region did little to discourage such sentiments.

The newly adopted EU Council Conclusions of 14th May 2012 support tying budget support more strictly to the political conditions in recipient countries and it has now become the EC's new official budget support policy. In future, different budget support instruments will be used according to the prevailing political conditions in the recipient country (see Box 1).

### Box 1: Three different budget support contracts:

Under the new approach, General Budget Support (GBS) will become 'Good Governance and Development Contracts' (GGDCs), Sector budget support (SBS) will become 'Sector Reform Contracts' (SRCs) and support to fragile states will be coined 'State Building Contracts' (SBCs). A key feature of this differentiated approach is the proposal to tie the provision of GGDCs to political conditionality and to only grant this kind of support where 'there is trust and confidence that aid will be spent pursuing the values and objectives to which the EU subscribes...'.<sup>2</sup> SRCs, on the other hand, are envisaged for countries where the political conditions for GGDCs do not exist. MDG contracts will no longer exist in their current form.

## Key design features of budget support

Budget support is highly relevant to the aid effectiveness agenda that has developed over the last decade. This has called for aid agencies to more closely align their strategies with the recipient government's own so as to avoid the creation of parallel structures and reduce fragmentation through better harmonized aid interventions. An inherent design feature of budget support is that financial resources are directly channelled to a recipient government's treasury account. Resources are thereafter executed using the country's own allocation, procurement and accounting systems, and therefore more likely to be aligned with the recipient government's development strategies

### Box 2: Aid Fungibility

Fungibility is where one unit of an asset can easily be interchanged with another unit of the same asset. If we assume the asset is money (here aid or domestic revenue), the fungibility of aid concerns how governments choose to allocate their domestic resources given an allocation of foreign aid. The problem (from a donor perspective) arises, for instance, when a government receives aid for a sector-specific purpose but then reallocates at least part of its own resources that were originally budgeted for this purpose and transfers them to issues of higher political priority. Thus, in the worst case, even ear-marked projects in social sectors can indirectly co-finance clientele networks, a repression apparatus, or even military arms races. This potential challenge of fungibility exists independently of whether aid is given through projects or budget support, but is potentially more acute with budget support.

Budget support was designed to support national development strategies, with a special emphasis on poverty reduction, improved service delivery, enhanced pro-poor growth and the realisation of the Millennium Development Goals (MDGs). It also aimed to support a range of institutional reforms in the public sector, such as improving the quality of public finance management (including budget transparency) at the national and sector level. By using government systems, it was thought that budget support would be less detrimental to domestic accountability than project aid as resources would become part of the government's own financial and accountability channels. In addition, budget support was supposed to ensure more predictable aid flows, with multi-annual commitments that allow for long-term engagement.

There are two distinct types of budget support: 'General Budget Support' (GBS) and 'Sector Budget Support' (SBS). Both these forms of budget support are administered through the recipient government's Finance Ministry or Treasury Department. So from a **technical financial perspective** there is no difference between the two, as all government to government aid is fungible (see box 2). However, from a **political perspective** GBS and SBS are different. Whereas GBS gives access to the high level policy dialogue in which overarching reforms regarding the public sector are discussed, SBS gives access to policy dialogue specific to a particular sector (ie health or education).

## From design to reality: budget support and political conditions in recipient countries

As more bilateral donors started to provide budget support its application shifted away from its original design. Several European donors included demo-

cratic governance and commitment to human rights within their eligibility criteria and linked budget support explicitly to democratic governance reforms. Other donors - like the EC and multilateral development banks - remained closer to the original design. For them budget support remained primarily linked to supporting the MDGs and more technocratic governance reforms. For the EC the link between budget support and democratic governance was therefore often far less pronounced.<sup>3</sup> These different approaches clearly indicate that donors tied different 'goal hierarchies' to budget support and this led to major coordination problems across the EU.

In many recipient countries progress on democratic reforms was not on a par with technocratic reforms. And donors would often disagree on their assessment of a recipient country's progress. Among donors that tied explicit democratic goals to budget support operations there were widely varying standards for assessing democratic progress (or deterioration) in recipient countries. Each donor explicitly reserved the right to interpret the political conditions in the recipient country according to their own subjective judgment. While this process afforded individual donor governments a high degree of flexibility, it also made the provision of budget support increasingly volatile and unpredictable, as it is easier to stop budget support than it is to stop a project. Furthermore, it made budget support less aligned and less coherent because recipient governments were often confronted with widely differing signals from different donors (Box 3).

Over time, GBS was perceived as highly political. Even though GBS and SBS are both fungible (see Box 2) they are not perceived as such. GBS is often perceived by the wider public as a 'regime' endorsement, whereas SBS is perceived to be unattached to regime issues and closer to service delivery and the beneficiaries. This is particularly relevant for bilateral donors because it points at the legitimacy risks of providing GBS to certain regimes. It also points at an apparent trade-off between hardware (technically right solutions) and software (feelings of legitimacy, values and beliefs).

The events of the Arab Spring further exacerbated these tensions: as the EC had provided direct budgetary support to Egypt and Tunisia, it was accused by certain member states of providing direct support to authoritarian regimes. The EC was criticised for giving too little weight to democracy and human rights issues in its budget support policies. This contributed to

the development of this new budget support policy in which human rights, democracy and development are considered important goals.

Notwithstanding this messy reality, budget support has achieved a number of important reforms. The modality has set important mechanisms in motion to improve donor coordination such as joint policy dialogues and joint conditionality frameworks (Performance Assessment Frameworks). In addition the financing function of budget support, related to improved discretionary expenditure and allocative efficiency, has been effective.

Budget support has assisted in increasing public investment and reform in social sectors through policy dialogue. This has contributed to countries achieving significant outcomes in education and in health.

There is also evidence that budget support has been instrumental in improving public financial management systems, including increasing transparency and independent supervision of the budget cycle. As such, budget support has been important in making budgets more transparent in a number of countries. This has resulted in more public debate and more public scrutiny of government expenditure and policies.

Despite its achievements, for those donors with the more ambitious goal of democracy promotion, the effectiveness of the modality has so far been low. Implementing the EC's new budget support policy, with its emphasis on political governance, thus poses significant challenges that are discussed below.

## Rationale for and against tying political conditions to aid

There are a number of good reasons why aid providers should not turn a blind eye to regime issues in recipient countries.

### Box 3: An example of exit chaos from Budget Support

In 2009 a major case of fraud was recorded in the Zambian health sector. This led to the suspension of Swedish and Dutch budget support disbursements. At the same time, the EC decided to release funds of its V-Flex instrument - a budget support mechanism specifically created because of the financial crisis. Incoherent strategy by different donors was the result of different interpretations of the fraud case and their different use of different budget support instruments. For some donors, it was a sign of increasing fiduciary risks and deteriorating governance in Zambia. Others read it as a sign of progress because the detection and subsequent prosecution of the fraud was perceived to be a consequence of strengthened regulations and oversight bodies (such as the Auditor's General Office).

Firstly, evidence suggests that aid is more effective in contributing to growth and broader measures of human well-being in countries with higher levels of democracy. These empirical findings are consistent with the fact that democratic governments have stronger incentives to provide more development enhancing public goods than their autocratic counterparts. Empirical findings also indicate that aid contributes to the political stability of a regime - no matter if democratic or authoritarian.

Secondly, there is the issue of donor legitimacy and accountability. The policies and actions of aid agencies are to some extent determined by domestic politics. They are influenced by interests at home and subject to concerns around democracy and human rights. As the EU defines itself as a community of countries that share the same fundamental values about democracy and human rights, the EC cannot neglect these issues in its international engagement. European donors are also accountable to their parliaments, the press and civil society organisations - actors which are often highly critical of aid going to authoritarian regimes with little or no respect for human rights and regimes with a peppered history of corruption scandals.

The question then is: how can aid be used to address democratic governance concerns? The aid literature provides some pathways to answer this.

One pathway is through **selectivity**. Donors unilaterally decide that certain standards have to be in place before giving aid. Given the evidence mentioned above, democratic governance standards can be used as part of selectivity criteria because the likelihood that aid will be better spent is greater in democratic contexts. The other pathway is to deploy political conditionalities as an **active lever for democratic reforms**. Democratic reforms are thus considered as part of the deliverables *through/during* the aid contract.

Unfortunately neither selectivity nor political conditionality come without serious challenges.

Increased selectivity leads to more aid going to relatively better-governed democratic countries which are often among the economically less needy. Rigid selectivity conflicts with the idea promoted in the Council Conclusions that budget support 'must be...targeted where it is needed most, where domestic resources are insufficient...'.<sup>4</sup> Another problem with applying selectivity in this way is that it runs the risk of sooner or later pushing a donor into using political conditionalities as a lever for change. Most developing countries – especially in sub-Saharan Africa – are situated in the grey zone between

autocratic and democratic political systems and move up and down the democracy continuum. Political volatility or crisis is often a regular pattern in such hybrid regimes. This volatility means that such countries may respond to political selectivity criteria in one moment, but not in the next. Selectivity can limit this risk to some extent but cannot 'free' a donor from having to deal with political deterioration when budget support is provided.

Using political conditionality as a lever for democratic reform is an even greater challenge. There is little evidence that such conditionality has led to gradual political change or turned autocracies into democracies. The notable exceptions were the processes of EU enlargement, where member states agreed to let the EC manage the accession and conditionality process according to a highly harmonized and jointly accepted scheme. The resulting conditionality packages were not only coherent, but were tied to the exceptional incentives of EU membership. Experiences in other developing countries, however, are sobering. Failed political conditionalities are explained by major collective action problems among donors: failure to provide coherent signals to the recipient due to weak harmonization; failure to impose credible sanctions or incentives; and failure to provide context sensitive incentives for augmenting local reform ownership.

The lessons from these experiences are:

1. Be context sensitive and contain sufficiently large incentives to boost existing levels of reform ownership.
2. Be well coordinated so as to present a coherent set of signals and incentives to the recipient.
3. Provide a set of credible sanctions in case of non-compliance.

## EU budget support and political conditions: the crucial issues at stake

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The review of evidence above regarding both selectivity and political conditionality relates to aid in general, not to a specific aid modality. This section looks at budget support specifically.

Given aid is fungible, linking budget support to political conditions makes little sense from a technical perspective. If a governance situation is considered inappropriate, all types of aid – not only budget support – should be given more selectively or used as a lever for change. Technically speaking moving out of GBS and into other modalities, such as SBS or proj-

ect aid, is just as 'regime-endorsing' as GBS.

However, the reality of aid is not merely about following technically right responses. Legitimacy and accountability in donor countries are equally as important. Given that parliaments, the press and civil society in donor countries are particularly sensitive towards GBS (while not grasping that aid is fungible) they will be more critical if GBS is going to authoritarian regimes with little or no respect for human rights, or to hybrid regimes where an event takes place which indicates intolerant, discriminatory or undemocratic politics. This criticism is to be expected even if such a regime is performing quite well in the area of economic growth, poverty reduction and technocratic reforms.

### The EU's new budget support policy: the plan in theory

In trying to reconcile technically right responses with legitimacy concerns, the EC and the EU member states envisage the future role of budget support as promoting human rights and democratic values. GGDCs will only be granted if a country's overall governance is on track<sup>5</sup> and as an instrument it will be expected to promote democratic reform. Budget support cooperation will be reassessed if the governance situation deteriorates.

In theory, the idea of democracy promotion through budget support builds on the idea that the interaction between political conditionality, financial disbursements and political dialogue would create an incentive system. This system would not only work in favour of pro-poor sector policies and public finance management reforms but would also be conducive for increasing democratic governance and accountability. When democratic governance or human rights are potentially threatened, the financial and non-financial components of budget support are to be used strategically to nourish a public debate and to provide political space for reform oriented actors.

Nevertheless there is a risk that budget support becomes over-politicised and overburdened to the extent that the initial objectives of budget support – a financial contribution to poverty reduction efforts and public sector reforms – are threatened.

Whether such strategy can work depends on a number of crucial preconditions and has serious implications for the role of the EU. However, these preconditions pose tremendous collective action challenges for the EU and beyond.

There is ambiguity in both the Communication and the Council Conclusions on the exact way po-

litical conditions in recipient counties should be tied to budget support. Poverty reduction and democracy promotion are both listed as objectives of the modality. However, the Council Conclusions do not indicate which goal is of primary importance. At the instrument level this becomes even more ambiguous. A SRC is supposed to be provided where conditions do not exist for GGDCs. Yet at the same time both a GGDC and a SRC are supposed to be used as a vector to improve governance.

### The implications of selectivity

The EC's new policy indicates stronger political selectivity when providing budget support without explicitly mentioning the criteria or mechanisms according to which countries will be chosen. **If selectivity criteria are set too high** it is likely to result in a large reduction of countries receiving budget support and the ability of the EU (commission and member states) to engage in high-level policy dialogue. This could weaken the EC's comparative advantage. Such a reduction in budget support is likely to be driven by a reduction in the number of GGDCs as compared to GBS operations in the past, for both supply and demand reasons. From a supply perspective, even if countries may be performing well in other more technocratic areas of reform, poor political governance will limit their access to GGDCs. From a demand perspective, GGDCs are likely to be less popular than GBS and hence less in demand by recipient governments. If a recipient country can access a form of budget support from another donor that has weaker political conditions and less ambitious expectations for improvement, why would it choose a GGDC?<sup>6</sup>

Such a large reduction of budget support, particularly of GBS/GGDC, may have serious consequences for the EU at the international level. It would lose its main mechanism for high level policy dialogue. And in doing so a process which allows a more comprehensive assessment of, and contribution to, a country's overall reform process. This high level access is also important because the EU claims it has a specific identity, and specific values and norms it wants to promote. As an international political actor and one of the largest donors, its visibility, presence and influence has been markedly increased by the use of budget support. In reducing budget support, particularly GBS, the EC risks losing access to all the fora where important

political issues are being discussed. These fora will then mainly be populated with development banks and their technocratic concerns.

Aligning the EC to the same restrictive eligibility criteria of member states significantly reduces the EC's scope of action. As a mere '28th donor' the EC would lose its comparative advantage and its powerful position in recipient countries may be weakened. If the EC aims to be a world player - visible, omnipresent, standing alongside large international donors such as the World Bank - it needs to retain its autonomy and leeway when handling budget support. This relates in particular to its role at the higher political level, where the EC should have a clear interest to be represented and to convey messages to recipient countries that transcend narrow technocratic concerns. The ability to take calculated risks and allow the more technical and political perspectives on budget support to prevail without being endlessly handicapped by constituency constraints is what defines the comparative advantage of the EC. This allows the EC to move and act in ways which European bilateral donors cannot, due to constituency constraints, legitimacy and accountability concerns and subsequent risk aversion.

### **The implications of using aid to leverage democratic reform**

**Using aid to leverage democratic reforms** requires coherence and coordination. Conditionalities will not work if a recipient is confronted with widely varying signals from different donors. The problem is that donors (including the EC) do not hold a strong track record in that respect. Tying very different policy objectives, such as poverty alleviation and democracy promotion, to one instrument furthermore violates the Tinbergen rule. This states that for each and every policy target there must be at least one policy tool. If there are fewer tools than targets then some targets will not be achieved.

To counter such overburdening of budget support the need for a common goal hierarchy is particularly important. This is especially so in emerging democracies and hybrid regimes where developmental performance is not necessarily synchronized with democratic performance in the short or medium term. By using budget support as a sanctioning device for underperformance in one area, it will automatically affect the other area as well. If budget support is to have a leverage function, donors need to have a common position on when

the governance objective is more important than the financing objective - even if it comes at the cost of undermining the financing objective. Waterproof coordination and harmonization are needed for such effective conditionalities. This includes a common interpretation of political criteria, such as democratic governance and human rights. It also requires a common interpretation about the kind of events that violate political conditionality, a coup d'etat? A corruption scandal? A media suspension? One political crisis, two?

Unfortunately, the Communication and the Council Conclusions neither formulate a consensus on the instrument's goal hierarchy nor articulate ambitious procedures to reach joint assessments and interpretations of potential violations of political conditionality. If such common understanding and full consensus is not possible, the effectiveness of the political conditionality will be undermined. Given that the track record of donors in developing such joint endeavours is not particularly good, the odds are that such conditionalities will not work and may undermine achievements in other developmental areas. However, if the EC and EU member states are not ready to take up these challenges, and to significantly advance their capacity and willingness for collective action, they need to rethink the weight given to promoting democratic governance through budget support.

Finally, the democratic standards European donors tend to promote are often not in tune with local dynamics. The democratic pace, transition and consolidation is intimately linked to internal political processes and sometimes to global dynamics. In such processes, donors can at best play a supporting role. This again highlights the importance of ownership. Without ownership and receptiveness from the recipient side, aid in general - and budget support in particular - will not be able to 'buy' deep political reforms nor transform autocracies into democracies.

### **Conclusion**

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The EC's new approach to budget support has been largely driven by the dissatisfaction of member states, who consider that the EU's policy has been too insensitive to political issues. Although there are a number of good reasons why donors should not turn a blind eye to governance issues, tying budget support more strictly to the political conditions in a recipient country is not without its pitfalls. It is unclear whether this attempt to protect some of the positive attributes

of budget support will in fact be its downfall.

Four interrelated messages have emerged from our analysis:

1. The idea of **accounting for political condition in varying degrees** to sector and general budget support operations makes little sense from a purely technical perspective. Yet from a political perspective, such approach is likely to shield the EC and the EU member states from domestic criticisms. Technically all types of budget support are equally fungible (see box 2 for clarification of term), so SBS is just as likely to be abused for corruption or spent for different purposes as GBS. However, the reputational risk associated with the latter is often perceived to be less than the former. This is largely because of a misplaced sentiment held by the wider public that SBS is less of an endorsement of a country's regime, subject to less fiduciary risks and closer to actual service delivery and beneficiaries than GBS. Seen in this way, applying political governance conditions differentially makes sense if it appeases those concerned about wasteful GBS aid and at the same time protects at least one form of budget support (SRC and SBC) and its associated positive attributes.
2. The Communication and the Council Conclusions are rather **ambiguous on how political conditions in a recipient country will be tied to budget support operations**. Both documents highlight that budget support and especially GGDCs (the new form of GBS) should be provided more selectively and that budget support should promote human rights and democratic values. Yet, there are no clear criteria for a selective approach nor is there a conclusive strategy on how to use budget support to leverage political change.
3. If rigid **selectivity** is pursued and the EC aligns with the same restrictive budget support policy of member states, it may undermine the EC's

comparative advantage and force the EC in to the role of the '28th European' donor with less engagement on high-level policy dialogue. The proposed political selectivity to be applied to GGDCs may result in a large drop in budget support. Fewer countries will be able to access GGDCs (than currently access GBS) and the recipient country demand for it is likely to be low. This will weaken the EC's ability to engage in high-level policy dialogue - important, not only for development outcomes, but also crucial for its visibility, scope of action and legitimacy. Thus, in giving more weight to democracy and human rights concerns, the EC must balance the challenge of becoming more selective without becoming too selective, so that its leverage and scope for action won't be significantly undermined.

4. For budget support to **leverage performance changes** in democratic governance, the EC and EU member states would need to introduce conditionalities that are in touch with existing reform efforts. They also need to address a tremendous collective action problem. Specifically, they would need to provide a well-coordinated, coherent incentive system for the recipient and also employ a credible set of sanctions in case of non-compliance. The ability of budget support to promote democracy and human rights will depend largely on the context (converging preferences between donors and partner countries) and on the ability to solve collective action problems between EU donors. However, given the sobering experience of the past in crafting and implementing harmonized political conditionality, the EC should be very careful about raising expectations that are not covered by a political consensus. If the EC and EU member states do not substantially advance the harmonization of budget support implementation, the modality will fail to achieve its political objectives.

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## References

1. Hereafter 'EC' refers to the European Commission. 'EU' refers to the European Union, which contains the European institutions and the 27 member states. The EC delivers aid and provides budget support. In the Council Conclusions (14 May 2012) on The Future Approach to EU Budget Support to Third Countries, the EC and the EU have agreed on one common policy for future budget support.
2. European Commission: 'The Future Approach to EU Budget Support to Third Countries'. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Brussels, COM(2011) 638/2
3. That said it is worth noting that the principle of democratic governance is often mentioned as an underlying principle for providing budget support in the Memorandum of Understanding between budget support providers and the recipient government.
4. Council of the European Union: 'Council Conclusions on the Future Approach to EU Budget Support to Third Countries'. Council of the European Union, Brussels, 14th May, 2012.
5. Ibid.
6. One suggestion is that the approval of a GGDC could offer a positive signalling effect for the recipient country, e.g. signal to other development and non-development financiers that the recipient is a more attractive place to invest than other countries. Another would be to tie a larger amount of financial support to GGDC (vis-à-vis SRC) to encourage demand, such as a 'more-for-more' approach that will be employed in the Neighbourhood.

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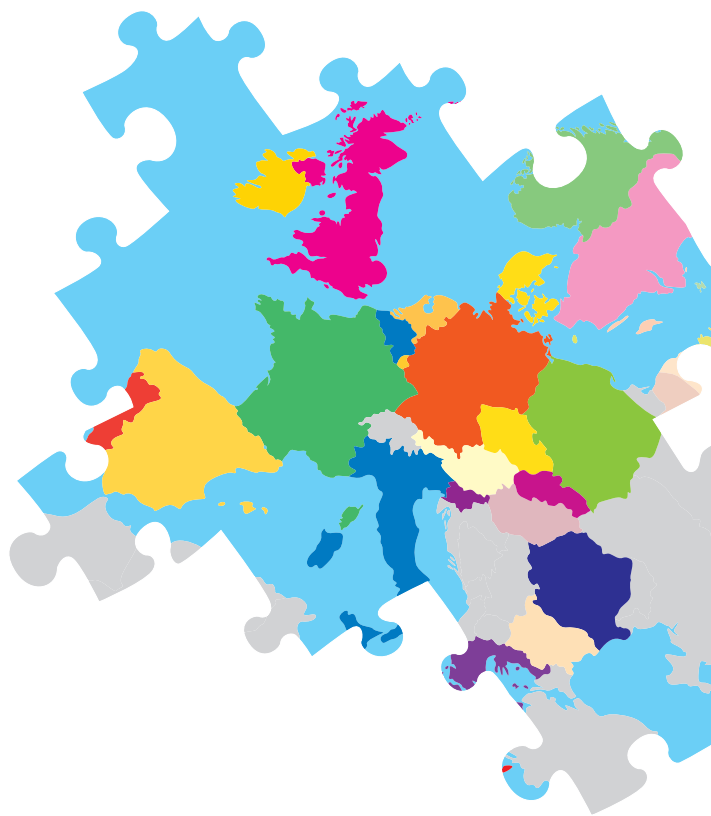
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