



Improving governance and Public Financial Management through budget support: The experience of the African Development Bank

**Gabriel Negatu, Emanuele Santi and
Kate Tench**

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DISCUSSION PLATFORM***Perspectives on budget support***

The debate on budget support has heated up the last couple of months. ECDPM contributes to a more nuanced and inclusive debate by offering this platform for discussion. The African Development Bank is the third partner to contribute. Previous voices from Luxemburg and Germany provided two donor perspectives.

This contribution from the 'premier development finance institution' on the African continent explains how the AfDB seeks to contribute to improved governance in Africa through increased use of budget support. Use of this aid modality is part of an aid instrument mix since "budget support alone may not lead to comprehensive reforms" required to deliver improved public finance management and accountability systems. The AfDB also argues that budget support has proven to be effective in certain fragile environments.

The views expressed in this contribution are those of the authors and should not be attributed to ECDPM, the AfDB or any other party.

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List of Acronyms

ADF	African Development Fund
AfDB	African Development Bank
DAC	Development Assistance Committee (OECD)
ECDPM	European Centre for Development Policy Management
HIPCs	highly indebted poor countries
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
PBO	policy-based operation
PFM	public financial management

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Introduction

Both Donors and partner countries increasingly prefer budget support as an aid delivery mechanism. The Paris Declaration on Aid Effectiveness (2005) helped to boost support for this instrument, as did, albeit to a lesser extent, the Accra Agenda for Action (2008). Budget support is seen as the instrument of choice for many donors and partners to help (i) avoid aid proliferation and fragmentation and the resultant transaction costs; (ii) increase the availability of resources for financing recurrent costs, which is an essential element of sustainability (Agbonyitor, 1998; World Bank, 2006); (iii) foster greater national ownership in the development process and in the use of official development assistance; (iv) strengthen public financial management (PFM) systems by integrating resources into national planning, budgeting and oversight functions; (v) strengthen predictability and timeliness of foreign aid (AfDB, 2004); and (vi) give donors a seat at the table in discussions of critical cross-cutting policy reforms.

But budget support alone is no panacea. While it has generally helped to strengthen PFM systems in Africa and has resulted in higher spending on basic services, for example, in health and education, expanded services have been at low quality (World Bank, 2006; OECD-DAC, 2006). Moreover, where there is macroeconomic and political instability, the perception of higher risk associated with budget support (especially fiduciary risk) can make the instrument more susceptible to interruption by donors than projects.

The research and policy consensus is that budget support will contribute to enhancing aid effectiveness and strengthening economic and financial management, thereby increasing the potential impact of government efforts to reduce poverty if recipient countries have a favourable policy environment (World Bank, 2006). The question of whether such a favourable environment is a necessary prerequisite for, or a result of, budget support is a key discussion point in many bilateral and multilateral institutions, including the African Development Bank (AfDB).

1 Overview of the AfDB's experience in budget support

In line with other development partners, the AfDB has increasingly been using budget support operations. It uses policy based operations (PBOs), defined as “quick-disbursing loans or grants with the primary objective of supporting policy reform programmes”. The AfDB is scaling up its use of PBOs alongside increased allocations through the African Development Fund (ADF). Over the 2005–07 period the AfDB provided US \$1.55 billion in PBOs, up from \$1.16 billion over the 1999–2001 cycle (AfDB, 2008). Under the current ADF cycle, ADF-11, over \$1.6 billion has been channelled through PBOs to 33 ADF countries. Including those countries eligible only for AfDB support, approvals for new PBOs in 2009 alone account for \$2.5 billion.

The AfDB's PBO framework consists of two types of aid instruments: (i) development budget support lending (general budget support or sector budget support, AfDB, 2004) and (ii) policy-based lending. The first, general budget support, consists of supplying a country's national budget with unallocated resources in support of the longer term development objectives of a national poverty reduction strategy, usually as part of joint programmes with other donors and in a common partnership framework. Sector budget support finances the national budget in the context of a sector strategy with dialogue focused on the sector (note that the funds are not earmarked). The second type of aid instrument, policy-based lending, is akin to other donors' balance of payments or import support. This support is used to mitigate short-term macroeconomic instability, to sustain reforms or to supplement country resources in cases where the fiduciary environment is too weak to permit budget support. The use and choice of the type of PBO are guided by the analysis of a series of factors, ranging from the existence of a country-owned development strategy to institutional capacity (box 1).

Box 1: Prerequisites for AfDB policy-based lending

- The existence of a country-owned development agenda, a poverty reduction strategy paper or a national development programme, endorsed by the donor community
- A country strategy paper-based analysis pointing to the existence of a viable and transparent budgetary process and the need for budget support to assist the government development programme
- A satisfactory Country Policy and Institutional Assessment (CPIA) rating in the preceding year, attesting to demonstrable government commitment to and performance on reforms and the existence of institutional capacity to sustain reforms
- Status of government-led aid coordination process, including a degree of donor buy-in
- The degree of harmonisation of donor procedures, including procurement systems
- Where institutional capacity has been assessed as weak or inadequate, the existence of a credible institutional capacity building programme which could be supported by the development budget support loan

2 Key features of policy-based lending in the African Development Bank

2.1 Focus on public financial management

One distinctive feature of the AfDB's budget support is its significant focus on PFM reforms. The Bank's focus on PFM was highlighted in the Governance Strategic Directions and Action Plan (AfDB, 2008), which provided a rationale for greater strategic selectivity and focus in AfDB operations.

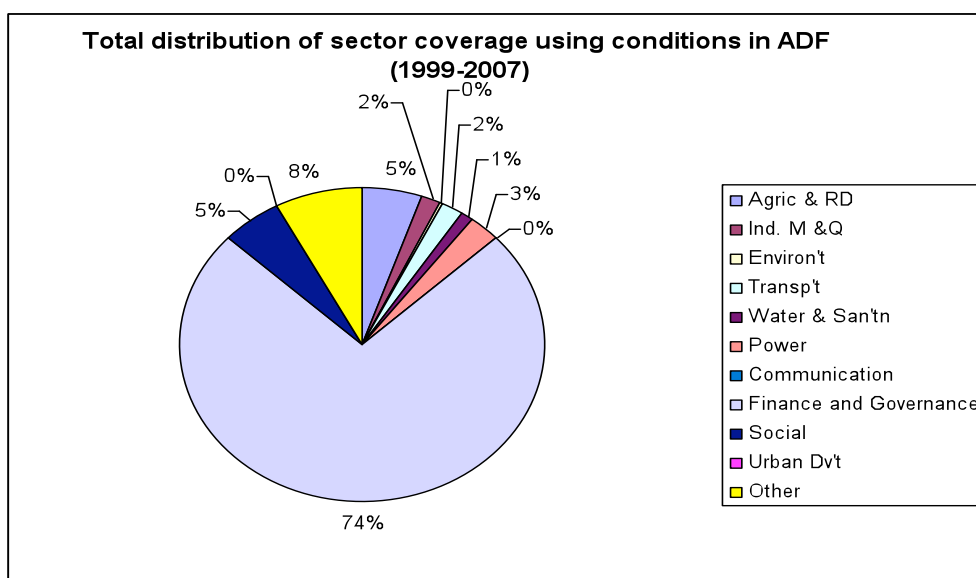
The Bank's reasoning for its focus on PFM is twofold. First, the AfDB prioritises PFM reforms as a critical output to achieve better governance and therefore realize greater results from all government revenues for poverty reduction. As indicated in the AfDB strategy, there is recognition that financial accountability and budget oversight are the weakest and riskiest links in PFM. Country PFM systems in Africa remain weak and need substantial improvement. According to IMF (2005), of the 26 highly indebted poor countries (HIPC) 24 require some or substantial upgrading of their PFM systems. As an African institution, the AfDB is committed to reversing these trends and is focused on building capable African states through its budget support programmes.

Second, the use of budget support requires improvements in PFM to ensure transparent and accountable use of ADF resources. Where appropriate, budget support is an effective instrument for securing improvements in PFM because, unlike traditional projects, it uses

national budget and accountability systems to channel aid thereby strengthening those systems. The OECD Development Assistance Committee (DAC) confirmed this in its Joint Evaluation of General Budget Support (2006). The evaluation found significant, measurable results on PFM outputs attributed to budget support, including budget comprehensiveness, allocative efficiency and transparency. It also found some accountability improvements as line ministries were encouraged to negotiate with the Ministry of Finance, rather than with donors, to secure funds. In this way, budget support also has the potential to give greater accountability to national parliaments.

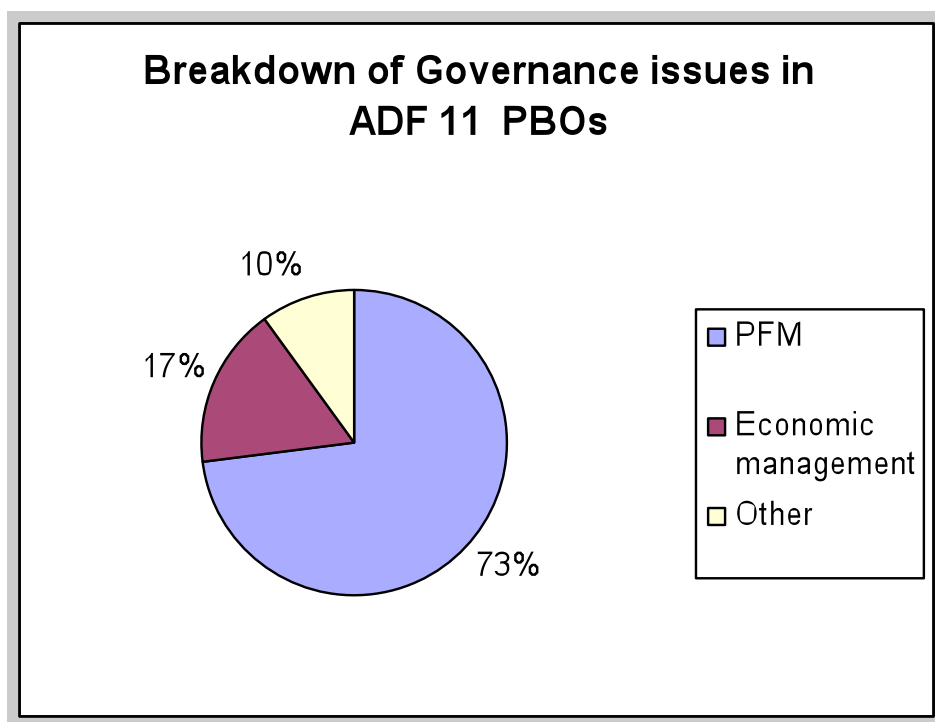
The AfDB’s focus on PFM was highlighted in its retrospective (AfDB, 2008), which shows that economic and financial governance is by far the dominant focus of the Bank Group’s PBOs, accounting for on average 74% of all conditions deemed necessary for disbursement between 1999 and 2007 (figure 1).¹

Figure 1: Sectoral focus of conditions for policy-based operations



This focus has remained through the current financing window of ADF 11 (2009/10 - 2011/12) with 74% of conditions relating to economic governance and PFM of which roughly ¾ relate to PFM (see figure 2) (AfDB, 2010). Key focal areas for the Bank’s economic and financial governance focus include budget, audit, tax and procurement.

¹ As a comparison, over the same period of time the World Bank’s International Development Association (IDA) had 55% of the conditions related to governance

Figure 2: ADF governance selectivity

2.2 Focused conditionality for predictability and harmonisation

The literature contains mixed evidence on the effectiveness of conditionality. Nevertheless, a general consensus is emerging on the need to streamline and consolidate conditions. This allows country stake-holders and donors to have focused discussions and informed debate on a limited number of monitorable policy measures. The AfDB portfolio reviews (AfDB, 2008 and 2010) highlight progress in reducing conditionality. From 2002–04 to 2008–09, for example, the average number of binding conditions in each PBO declined from 11 to 7 for low-income countries (ADF) and from 25 to 9 for ADB countries. Most recent budget support approvals also show the Bank's increasing preference for using prior actions and for aligning disbursement conditions to joint government-donor performance assessment frameworks to enhance predictability, harmonisation and alignment (box 2). As the World Bank's (2006) own review indicated, conditionality needs to be used much more carefully than in the structural adjustment era, taking into account the goal of encouraging country policy ownership and the available evidence on the types of conditionality that have some chance of working. This lesson is being implemented by the AfDB, which progressively targets strengthening of country ownership.

Box 2: The case of Mozambique

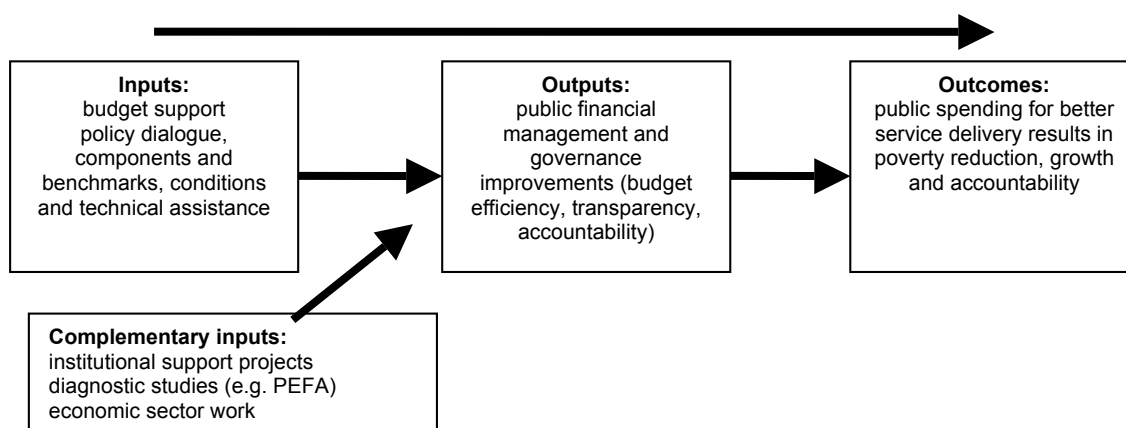
The 60 million units of account budget support to Mozambique approved in 2008 is a good example of donor alignment. The support framework incorporated prior actions allowing the Bank to frontload the first tranche, as well as permitting the subsequent tranches to be exclusively dependent on the overall satisfaction with the joint donor-government performance assessment framework (PAF).

2.3 Complementarity

The AfDB is increasingly aware that budget support alone may not lead to comprehensive reforms. For this reason, budget support is increasingly used as part of an aid instrument mix to reinforce the impact of AfDB operations. The menu of budget support inputs towards improved

PFM goes beyond the provision of funds to encompass policy dialogue and alignment at the country level (figure 3). In addition, knowledge products such as diagnostic studies and analytical work at both the country and the regional level help share good practices. Alongside PBOs, the AfDB delivers complementary institutional support projects to help strengthen institutional capacity, especially in areas of high fiduciary risk. 80% of PBOs in low income countries have a complementary technical assistance programme for capacity building (AfDB, 2010).

Figure 3. Budget support inputs, outputs and outcomes



Source: Adapted from the enhanced evaluation framework in OECD-DAC (2006).

While policy-based instruments are generally used to support structural policy reforms, institutional projects and technical assistance are used to strengthen the capacity of institutions to undertake and sustain reforms. In Tanzania, for example, the combination of budget support and capacity building projects has led to major improvements in the country's procurement system. While the former provided the impetus for the government to implement procurement reforms, the latter consolidated gains by strengthening the Public Procurement Regulatory Authority (PPRA). In the Gambia, a mix of instruments was designed to strengthen both capacity and structural policies. The interventions combined to deliver increased tax revenue (from 17% of GDP in 2008 to 20% in 2009), increased poverty-related expenditure (to 50% of the budget in 2009) and more timely audits (reducing the backlog from seven to two years between 2007 and 2009).

2.4 The AfDB, an African voice on economic and financial governance

As the premier development finance institution on the continent, the AfDB is strategically positioned to promote economic and financial governance in Africa. It has a comparative advantage here, owing to its close collaborative relationship with its member countries and its selective focus on economic and financial governance. The Bank gives voice to Africa's priorities and perspectives on governance in international debates. This is of particular relevance for policy dialogue embedded in the budget support process. In Burkina Faso, Madagascar, Rwanda, Malawi and Tanzania, the AfDB has chaired the donor budget support group, playing the role of facilitator and trusted policy broker between governments and development partners.

3 The challenge ahead: The chicken or the egg dilemma of budget support

Budget support works best where there is a good policy environment, including good standards of PFM (World Bank, 2006). But it also helps deliver better PFM standards. Using PFM thresholds to inform the choice of budget support as an aid instrument helps to ensure that funds will be well accounted for and fiduciary risk minimised (although determining the appropriate threshold level and using joint assessments to score performance bring their own challenges). So threshold levels of PFM allow budget support, which in turn helps to strengthen PFM. *But are thresholds really necessary?* Budget support has also proven to be effective in fragile countries immediately post-conflict when the PFM system was very weak at the time they started receiving budget support from donors (OECD-DAC, 2006). The cases of post-genocide Rwanda and, more recently, Liberia show that budget support can be a tool to provide countries with the resources and latitude necessary to emerge from a post-conflict setting, as well as to empower and build government capacity for the longer term. Without the flexible resources provided by budget support, Rwanda might have been unable to strengthen its PFM system so quickly. This suggests that budget support can be just as effective in cases where threshold levels of PFM are not yet in place but where government is strongly committed to good governance and improving performance. In such cases, evidence of commitment and improving performance over time against PFM standards (“trajectory of change”) may be more important than baseline PFM conditions per se.

This dilemma has direct implications for the ability of donors to provide budget support in fragile states in particular. Fragile states may be committed to improving PFM but have limited ability to provide detailed information or to meet minimum thresholds in the short run, before benefiting from budget support. Hence the fiduciary risks of providing budget support in these countries are high (there is no guarantee that the funds will be used effectively). But budget support may well be the best instrument to provide systemic PFM strengthening, as was the case in Rwanda and Liberia. Indeed, the counterfactual “risk of non-action” may be higher and lead to further deterioration of the state, as government commitment may not be matched by the necessary resources to deliver on promises.

The AfDB, and other budget support donors, should neither take unmanaged risks nor close their doors to emerging requests where fiduciary systems are, at best, a work in progress. Rather the solution is to review, in partnership with others, the fiduciary risk associated with a particular budget support operation and to design robust fiduciary safeguards to ensure that budget support resources are used for their intended purposes: in support of a national development plan or poverty reduction strategy. Robust fiduciary safeguards help minimise risks while achieving the benefits expected from budget support in fragile states. As an African multilateral, the AfDB has a particular role in providing predictable budget support to fragile states. In this regard, the AfDB, in collaboration with the European Commission and the World Bank, is working on a common approach to help pool and manage risk, as well as to share lessons on fiduciary safeguards. After all, budget support has proven to help rebuild the economic and financial architecture of post-conflict states, in a way that other aid instruments have been unable to do. The challenge for donors is to exploit this strength in a way that minimises the impact of fiduciary risk. And that implies a better understanding of the optimal design of safeguards.

*Governance, Economic and Financial Management Department
African Development Bank
Tunis
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The European Centre for Development Policy Management

Onze Lieve Vrouweplein 21

6221 HE Maastricht, The Netherlands

Tel +31 (0)43 350 29 00 Fax +31 (0)43 350 29 02

E-mail info@ecdpm.org www.ecdpm.org (A pdf file of this paper is available on our website)

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