

Perspectives on Budget Support

Why and how we are delivering

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DISCUSSION PLATFORM***Perspectives on budget support in the post Accra era***

“Few aid instruments have caused such vigorous political debate as budget support in discussions on how aid can best be delivered.” Thus opens Ingrid-Gabriela Hoven the second contribution to the Discussion Platform in which donors and key developing partners are invited to present their views on the use of budget support.

Lux-Development was the first to contribute (March 2009) to this platform, which ECDPM launched in order to contribute to the debate on aid and development effectiveness, and the related discussions on the choice and mix of aid modalities.

Although donors remain free to choose their preferred aid modality, they also have committed to progressively use partner country systems. Some donors have opted for budget support as the best modality to fit this purpose. Others disagree. And in general, there are varying degrees of reluctance to shift to this aid modality in a meaningful way. This contribution clearly argues why “Germany stands behind and promotes budget support as an aid modality”.

It is hoped that this discussion platform provides a learning opportunity on the relationship between aid modalities and the implementation of the Paris and Accra agendas.

The views expressed herein are those of the authors and should not be attributed to ECDPM or any other party.

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Budget Support: Why and how we are delivering

Introduction

Few aid instruments have caused such vigorous political debate as budget support in discussions on how aid can best be delivered. This is certainly true in Germany, where discussions on the pros and cons of budget support have reached a high level of attention in Parliament but also among civil society. It is often forgotten that these discussions have their origin in evaluations of the effectiveness of aid. At the end of the last millennium the international community took stock of joint efforts to fight poverty and promote sustainable development. They found that, notwithstanding all of the efforts and international development funds spent over the decades, more clearly needed to be done, not just in financing, but also in terms of effectiveness. A thorough search was necessary for more effective ways to spend the funds received in order to achieve significant poverty reduction in a world where billions of people still live in poverty, one billion of them in absolute poverty.

Ambitious targets are achievable only with better functioning government institutions. Decades of development cooperation have shown that this is not a mere technicality. Real developing country ownership, strong national institutions and country systems, harmonised development partner processes, improved results and impact orientation and genuine partnership based on mutual accountability must be principal parts of the future development agenda. The Paris Declaration on Aid Effectiveness and the Accra Agenda for Action (AAA) reflect this thinking, and Germany – amongst many others – signed and adopted these documents as guideposts. Germany did not just sign them, but also brought its own specific experiences to the design of these documents, demonstrating ownership of what was negotiated. Budget support is seen by many in this context as a high-potential instrument for fostering reform processes, strengthening country systems and facilitating increased public spending to achieve poverty reduction and development objectives.

Germany stands behind and promotes budget support as an aid modality. It is one specific reaction to the Paris Declaration and Accra Agenda. In December 2008, with its policy paper on budget support, Germany set out the circumstances under which it considers budget support and programme financing as the right instrument in its cooperation programme. In addition, its national implementation plan for the Accra Agenda foresees increased use of programme-based approaches (PBAs), budget support being one modality to support these. We are aware that budget support is no panacea; it cannot substitute for government ownership. But under the right conditions it can provide a good stimulus for Governments to move on with their reform agenda and to strengthen country systems. The entire budget support approach goes well beyond the structural adjustment programmes and balance of payments support we know from the 1980s and early 1990s. The German approach to budget support uses clear entry criteria and sets conditions to prevent misuse of the instrument or to prevent it from being discredited through a too simplistic application. Budget support can be a strong development force, if it is used under conditions and in countries where its comparative advantages can be built on. Where Germany does provide budget support, it strives to be a reliable partner that makes a significant contribution.

1 Why does Germany give budget support?

Today, more than one billion people still live on less than one dollar a day. The international community has therefore resolved to reduce global poverty to achieve the Millennium Development Goals. Germany is making a major contribution to fulfilling that pledge and considers budget support to be one instrument that can be appropriately used to support

national poverty reduction programmes and partner country leadership and ownership. Budget support can be applied most effectively, efficiently and flexibly in reform-oriented countries that have adequate strategies, high funding requirements and are heavily dependent on external aid. Budget support is a particularly good instrument for fostering long-term, complex reform processes and facilitating increased public spending in partner countries in crucial poverty-relevant sectors such as education and health.

There is broad consensus amongst developing countries and development partners, including Germany, on the need to improve the effectiveness of aid. Evaluations have shown that purely project-based cooperation can no longer live up to the elevated standards that have been set for aid effectiveness. Duplication, fragmentation, parallel implementation structures, lack of partner country ownership, lack of alignment of development partners to partner country strategies and processes, lack of harmonisation of procedures, a limited focus on results and impacts, and limited mutual accountability are still very much part of international development cooperation. This is particularly true in the poorest of countries, which are weak in resources and capacities. Development cooperation has therefore undergone a process of change in recent years, moving away from individual projects and focussing instead on programmes and sector-wide approaches. The Paris Declaration on Aid Effectiveness (2005) and the Accra Agenda for Action (2008) set out principles for effective aid, and Germany considers its own thinking on bilateral cooperation as being reflected in Paris and Accra. These declarations explicitly call for the expansion of programme-based approaches, budget support being one important aid modality to support these. Budget support can enhance the structural effects of development cooperation and reduce the high transaction costs associated with purely project-based cooperation, especially in countries with numerous development partners and a high degree of fragmentation. It can produce a deeper, more strategic political dialogue with the partner country and improve coordination of development partners, alignment and harmonisation.

But it is also clear that a new type of funding and an increased emphasis on aid effectiveness will not automatically lead to sustainable development processes. Providing budget support becomes difficult to justify if there is no prospect for improvement in governance. Accountability of governments to their parliament and citizens is an important checking mechanism to improve public spending. Public financial management needs to be improved, otherwise more money will not lead to more development. But what is true of partner countries is also true of development aid. The mutual accountability and transparency standards that are necessary to improve national long-term capacities, and even democratic accountability to citizens, are oftentimes not met by development partners in countries relying to a significant extent on development partner financing. Budget support is always on-budget, and that is an important first step. Development partners cannot preach democratic accountability to partner governments and at the same time allow perhaps 40 per cent or more of a sector budget to remain unknown to the Ministry of Finance, Parliament and the citizens of the country due to a lack of transparency on the development partner's side.

Budget support is sometimes perceived as being driven as much by the interest of development partners to disburse more quickly as by the need to scale up support to achieve the Millennium Development Goals. Achieving the MDGs is obviously not feasible without additional and sustainable, medium- to long-term financing. However, the financing objective is only one of the objectives of German budget support. In providing budget support, Germany pursues three objectives:

1. the **governance objective**, effectively shaping the political dialogue on sectoral and cross-sectoral issues and providing targeted support to institutions. In particular, our aim is to strengthen state institutions, boosting their capacities for public financial management and public scrutiny, and promoting political dialogue on respect for human rights, democratic participation, the rule of law and gender equality;

2. the **effectiveness and efficiency objective**, focussing budget support on poverty reduction and consistently implementing the principles enshrined in the Paris Declaration and Accra Agenda for Action;
3. and finally, the **financing objective**, funding the implementation of the partner country's strategies for achieving the Millennium Development Goals.

2 What is the German perspective on the comparative advantages and risks associated with budget support?

Budget support, if used in the right environment, has comparative advantages that make the risks associated with this instrument well worth taking. Compared with project-related approaches, we see the main comparative advantages of budget support as follows:

- It strengthens partner country ownership, as it does not create parallel structures or shadow budgets but operates through national systems, structures and institutions in the partner country. It does not take responsibility for policy and politics, strategic direction and reforms away from the partner country, its government and parliament. Pro-poor spending is fully integrated into the budget. And the budget is subject to national parliamentary scrutiny and becomes more transparent for civil society and the media.
- It strengthens the national budget process as a central policy instrument at all stages and permits more comprehensive long-term planning. This perspective enables policy coherence in fund allocation to the various poverty-relevant sectors (e.g. to primary education and health, instead of primary education or health). It further ensures that adequate account is taken of recurrent costs (unlike the external financing of investments without any guarantee of counterpart funding).
- Budget support raises to a higher level the political dialogue between development partners and the partner country. It necessitates transparency both on the national budget and on development partner funding, while focussing discussions on key policy issues as a precondition for overall development success (rather than looking narrowly at technical issues at the project level without taking account of the enabling environment).
- It advances the process of harmonising development partner procedures and, in particular, helps to reduce transaction costs on both the partner country and development partner sides in the medium and long run (budget support forces development partners to harmonise their procedures much more since it excludes those who are unwilling to use country systems).

However, budget support also involves fiduciary, macroeconomic and political risks related to the direct payment of development partner funds into partner countries' national budgets. German development cooperation analyses these risks together with other development partners for each individual case, taking into account the partner country's specific context. With capacities in many least-developed countries still being limited, this means that an appropriate system of risk management has to be applied. Risk management covers the selection of countries, close monitoring of the mutual accountability mechanisms used in the budget support programme and indicators of success incorporated into performance assessment frameworks. It also includes accompanying technical cooperation measures, especially but not exclusively in the areas of public financial management and monitoring and

evaluation. Involvement in the political dialogue is another important aspect, especially in those areas where Germany can build on particular competencies generated through its multi-level approach and presence. Budget support programmes further require a system of division of labour. One development partner alone cannot deal adequately with all parts of the government budget. The risks can be further reduced if there is sufficient information from involvement in different sectors at different levels of the state to see whether reforms are working, whether progress is being sufficiently monitored and whether funds not only reach the intended groups but are also effectively and efficiently used and lead to effective poverty reduction. Still, the instrument always entails certain risk taking. Budget support is used to leverage reforms, it is not just meant as a financing mechanism to be implemented once all necessary reforms have been successful.

3 Budget support: For whom and under what conditions?

The decision to provide budget support is based on an analysis of the risks, which are then balanced against the potential advantages. Germany provides budget support on a selective basis. The instrument is primarily offered to low-income countries with a strong commitment to reform that rely heavily on external development partner funding and are verifiably taking ownership of implementing their national poverty reduction strategy.

From this it is clear that budget support comes with conditions. Memoranda of understanding (MoU) often set out underlying principles for the instrument (e.g. peace, respect for human rights); yet not all developing countries adhere to these principles. Hence, not every country is eligible for budget support. The more general conditions raised above (e.g. commitment to reforms, ownership of national reform programmes) are analysed in the overall assessment of the achievement of performance targets set out mutually for key sectors and areas. The performance targets used in today's budget support programmes reflect a different approach than the conditionalities used in structural adjustment programmes in the 80's and early 90's. They usually build upon the partner country's national poverty reduction programme and sector strategies. Performance targets are derived from these partner strategies. The conditionalities are also fewer in number and hence better manageable as per lessons learned from previous programmes.

Germany's participation in budget support programmes is conditional on certain minimum requirements (eligibility criteria):

- Budget support is provided only to countries with good governance and sufficient administrative capacity. This criterion is assessed and evaluated using the comprehensive catalogue of criteria developed by the German Development Ministry (BMZ) for its overall cooperation framework with partner countries. All areas enshrined in the catalogue – including human rights, the rule of law, democracy and peace – should satisfy at least medium standards of governance. The country's willingness to carry out political reforms and its momentum towards political reform must be above average.
- Public financial management must be sufficiently transparent, efficient and effective to ensure that fiduciary risks can be contained (although Germany does not ask for perfection as an entry point). Deficiencies should be worked on and can be overcome by targeted measures implemented by German or international capacity building support.
- The macroeconomic situation must be sufficiently stable. Here, the assessments of the International Monetary Fund (IMF) are an important reference, although we do not systematically tie our budget support to IMF programmes.

In fragile states, such as post-conflict countries with reform-oriented governance heading towards a promising but politically risky transformation, Germany can offer budget support on an exceptional basis (where a policy decision is taken to deviate from the general eligibility criteria stated above). Yet, within the framework of joint financial arrangements, Germany's preferred option in these cases would generally be basket funding or participation in Multi-Donor Trust Funds (MDTFs) which entail significantly fewer fiduciary risks for the development partner.

4 What principles do we apply when using budget support?

Germany's approach towards budget support also entails the right mix of instruments. We strive to optimise the mix, as the comparative strengths of budget support emerge best when it is combined with other relevant development modalities, such as accompanying capacity development measures. Budget support cannot fully replace programme- and project-based development cooperation, but combined, the effectiveness of these modalities can be significantly enhanced.

Leadership from the partner country is crucial for success. Without real ownership and leadership for the reforms backed by budget support, the budget support programme cannot do the trick. It can, however, provide the incentive to tackle reforms or move them forward more energetically.

Cooperating with other development partners is also crucial. German contributions are always made jointly with other development partners that provide budget support, such as the World Bank, the European Commission and other bilateral development partners, with leadership by the partner country. This fosters aid effectiveness, draws out comparative advantages and funding sources of different players and allows a more focussed and structured political dialogue.

Predictability of budget support is another key element. German budget support is clear, predictable and aligned to the partner country's budget cycle, allowing our partner countries to integrate the funds into national budget planning at an early stage. We see budget support as a medium- to long-term instrument to support complex, continuing reform processes. The recent German Parliament budget committee's stronger involvement in the process of approving individual budget support operations strengthens accountability in Germany, but also poses particular challenges to predictability. However, the approval of the BMZ policy paper for budget support in December 2008 has been an important step - it lays out the eligibility criteria for German budget support, thereby increasing transparency on the use of this modality.

Germany supports performance criteria in budget support programmes that promote reform. Mutual accountability is a central aspect of budget support. Conditions are agreed on the basis of reform objectives derived from partner country strategies and defined in collaboration with the partner country and the budget support development partners involved. An acceptable rate of fulfilment of these conditions is part of the performance assessment review which forms the basis for new budget support commitments.

The principles applied by Germany with regard to conditions are the following:

- supporting the key objectives of national poverty reduction policies;
- ensuring consideration of general underlying criteria for budget support, like respect for human rights and empowerment of women;
- creating performance incentives by discussing and jointly agreeing on appropriate performance indicators, rewarding achievements with new commitments and designing country-specific fixed and where applicable, variable disbursement tranches;
- fostering harmonisation of development partners engagement and financial support through the adoption of a clear, simple and effective framework agreement (MoU) including underlying principles and mechanisms of interaction and decision-making; joint, transparent, relevant and selective performance targets and indicators embedded in a binding policy matrix; and mutual accountability standards;
- making sure that budget support does not substitute for national efforts to increase tax and other revenue in the partner country but is providing the right incentives to mobilise domestic revenue;
- agreeing on and ensuring the application of a clear, predictable, transparent and sensibly sequenced response mechanism if agreed underlying principles and performance targets are not met (avoiding stop-and-go decisions, setting incentives and clear signals, using gradual and proportionate reactions if possible etc.).

When using budget support as an instrument, particular focus is on performance evaluation and results orientation. We review the development effectiveness of budget support by participating in the annual joint performance assessments carried out in the countries themselves. These provide information on the progress made on reforms. We also carry out independent evaluations jointly with other development partners in-country and across countries. The German Parliament receives an annual report on budget support operations. In addition, German development cooperation is involved in the development and joint implementation of a methodology to assess the long-term impact of budget support on income poverty. While outcomes are difficult to demonstrate in the short term, positive trends are important to show. Nonetheless, results and outcomes are monitored and demonstrated for the medium to long term.

5 What topics does German development cooperation focus on in budget support efforts and how does it deliver?

Budget support programmes provide opportunities to link with specific thematic profiles in German development cooperation. Through involvement in the institutionalised budget support dialogue, it is possible to feed experience gained from the implementation of thematic programmes and projects into the general sector dialogue. Such exchanges can raise the relevance and visibility of these programmes in the partner country. We distinguish a sector-specific profile and a cross-cutting profile. Regarding the sector-specific profile, German development cooperation focuses on a maximum of three focal areas or sectors. Our know-how and relevance in these sectors can be fed back into the dialogue initiated through the budget support programme. A particular value-added is our sector-specific work at different levels of administration (ranging from central to the local level), which allows for informed

practical and pragmatic suggestions to the budget support programme.

As part of our cross-cutting profile, our aim is to introduce into the policy dialogue topics that play a significant role in the implementation of budget support. Examples are the following:

- promoting a functioning public financial management system with a particular focus on governance and gender objectives;
- strengthening the partner country's own financing capacities by modernising tax revenue systems and working on the preconditions for this (by improving economic infrastructure and the economic policy environment for private sector activity);
- increasing accountability and public scrutiny by promoting especially the role of courts of audit and budget committees in national parliaments;
- strengthening civil participation in the context of budget support by supporting dialogue forums involving government, development partners and civil society, and by promoting and strengthening civil society organisations;
- enhancing joint impact evaluation and aid evaluation systems.

Participation in budget support programmes stipulates both effective cooperation with other development partners, based on the principle of division of labour, as well as among the different German development actors, i.e. the Federal Ministry for Economic Cooperation and Development (BMZ), KfW Entwicklungsbank (German Financial Cooperation) and GTZ (German Technical Cooperation). If, following appraisal by the German budget committee, a decision is made to engage in budget support, BMZ commissions the KfW to implement and manage the budget support programme and coordinates the inputs of KfW and GTZ in the sector-specific and cross-sectoral work. Via the German embassies, BMZ is then involved in policy dialogue to a greater degree than when providing project support.

Budget support means that the partner country's administrative capacities have to be strengthened. This is why our aim is to combine financial with technical cooperation. We believe that the two complement one another and generate synergies. By accompanying budget support with advisory services through technical cooperation at the sector and national levels, the aim is to create a conducive environment for the implementation of the reform programmes we are supporting jointly with other development partners. German advisory services are coordinated with the work of other development partners and follow the division of labour principle. Technical cooperation contributions are provided either directly or through pooling of technical assistance.

6 Conclusion

An increasing number of multilateral and bilateral development partners are using budget support in a growing number of partner countries. Germany is committed to this new instrument and actively participates through its bilateral cooperation funds in those countries where it sees high potential in terms of improving governance and aid effectiveness and financing. It is important to understand that in German development policy, budget support goes well beyond a financing objective to achieve the Millennium Development Goals. It also carries medium- to long-term expectations of strengthened democratic accountability and good governance in partner countries and greater effectiveness of support in general. While Germany's decision to contribute to a budget support programme is made on a case-by-case basis and preceded by an analysis of the opportunities and risks, we are committed to increase the use of this instrument. This should be seen in the wider context in which Germany, through its significant financing for multilateral institutions, particularly the EU, is actively involved in budget support programmes and the decisions associated with them. In the context of our bilateral cooperation we view budget support as an instrument that complements other development instruments and helps to optimise our overall portfolio in the interest of enhanced aid effectiveness. We will expand the use of the instrument where conditions are right. Furthermore, we will participate in the further development of methods used in association with this innovative instrument and the monitoring of its results. By providing budget support, we are contributing to the implementation of the Paris Declaration and the Accra Agenda for Action, which we see as a framework for improving the effectiveness of our bilateral support. German development cooperation has a clear expectation that budget support will not only bring us jointly closer to the achievement of the Millennium Development Goals but also provide the basis for stronger leadership and ownership by our partner countries.

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