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Budget Support as an Aid Instrument – neither Pandemonium nor Panacea

Programme-based approaches, including sector and general budget support, are core elements of the Paris Agenda for more effective aid. This agenda emerged from an intense international debate that has since the mid 1990s centred mainly on modalities and instruments best suited to improving the effectiveness of international development aid.

Yet, budget support continues to be a highly contentious issue in Germany's and other donor countries' development policy debates. While in development cooperation practice, budget support has evolved into a fairly well established instrument to support poverty reduction strategies in developing countries, the broader political debate on the topic is generally ill-informed.

In practice, there is a broad consensus that budget support is suited only for a limited group of countries, that it should always be used in conjunction with other instruments, and that the instrument's potential benefits need to be weighed against possible risks. As a consequence, in many donor countries budget support continues to account for only a minor share of bilateral aid (2.5 % of German bilateral commitments in 2008).

Despite widespread scepticism, budget support has evolved into a reasonably well-established aid instrument in a number of developing countries, arguably with positive effects at least with respect to donor coordination and alignment to country strategies and systems. In addition, early experiences and evaluations confirm that budget support can be an effective instrument when it comes to strengthening the quality of policy dialogue, transparency and accountability in budget management, and enhancing donor coordination.

At present, however, there are hardly any robust studies of the instrument's concrete effects on poverty. At the same time, there is a growing discussion on the use of budget support to finance goals other than the Millennium Development Goals (MDGs), such as adaptation to climate change. This would risk the instrument's potential effectiveness for development. A central challenge for development cooperation is therefore the need to develop adequate evaluation methods for budget support. Another is to ensure that the instrument is not overloaded with new demands and goals. This will pose a conceptual and political challenge for German development cooperation.

The debate on budget support

Notwithstanding the broad consensus at the international level as well as within donor countries that aid needs to be made more effective, there seems to be far less agreement on how internationally agreed principles for more effective aid could and should be put to practice. In this regard, the use of budget support as an aid instrument continues to be a highly contentious issue in the political debate on aid and aid effectiveness in most donor countries, including Germany.

This is in some contrast to the observation that in a number of developing countries the instrument has evolved into a fairly well-established aid modality, with positive results at least regarding donor coordination and alignment. Yet, at the same time as a lot of the controversy among actual aid practitioners seems to have subsided, the debate on budget support as an aid modality has progressively moved from relatively confined expert circles into the wider political and public domain in a number of Western donor countries such as Germany, the Netherlands, and Sweden.

Much of the public discussion, however, continues to be shaped by misinformation and misconceptions about the instrument. This goes in particular for the – often overestimated – relative importance of budget support in overall German development cooperation (see box, below). Against this background, the aim of this briefing paper is to put opportunities and risks connected to budget support into perspective and thereby contribute to rationalising the ongoing political debate in Germany surrounding budget support to developing countries.

Background: international debate on aid effectiveness

In what some consider a veritable paradigm shift in the international development policy debate, it has been proposed that so-called Programme-based approaches (PBAs) should replace the traditional project-based approach in development cooperation. Besides other forms of coordinated aid, PBAs are commonly understood to include the provision of direct budget support to governments in developing countries.

The point of departure for efforts to devise more effective aid modalities was predominantly motivated by the disappointing record (and resulting criticism) of more than forty years of project-based aid. In a nutshell, aid projects were often found to produce only locally limited effects while being burdened with high transaction costs; they would tend to generate little or no ownership on the part of partners, neglecting structural and systemic problems; they could weaken partner institutions by establishing parallel processes and structures as well as through brain drain of qualified staff; and, finally, they put additional strain on already scarce administrative capacities needed to meet the manifold management and reporting requirements created by these parallel structures.

In addition to this technical criticism of project-based aid, the development community has come to realise since the early 1990s that development successes in partner countries hinge crucially on the quality of governance. Donors also have had to realise that they could exert only very limited influence on the quality of governance with the isolated project approach pursued in the past.

It was from this critique that a broad international consensus emerged on a new aid "philosophy". This was given concrete shape in the Paris Declaration on Aid Effectiveness of 2005, formulated jointly by representatives of donor and partner countries and signed by 92 nations, 26 international organisations, and 14 civil society groups.

The five core principles of this new aid agenda are ownership, alignment, coordination and harmonisation of donor activities and practices, managing for results, and mutual accountability.

To implement these five principles for more effective aid, the Paris Declaration proposes so-called programme-based approaches (PBAs), defined by the OECD-DAC as aid with the following features: (i) leadership by the host country or organisation; (ii) a single comprehensive programme and budget framework; (iii) a formalised process for donor co-ordination and harmonisation of procedures for reporting, budgeting, financial management and procurement; and (iv) efforts to increase the use of local systems for programme design and implementation, financial management, monitoring and evaluation.

In addition to the five principles for a more effective aid, the signatories of the Paris Declaration also committed to a set of 12 targets backed by measurable indicators. One of these targets calls on signatory donors to provide, by 2010, 66 % of their aid in the form of PBAs, an ambitious target for most donors: In 2007 Germany, for example, reached a figure no higher than 24 % (Ashoff 2008).

It is important to note that PBAs do not prescribe any particular aid instruments. In principle, very different aid instruments may be used to implement and support PBAs, ranging from single projects within the framework of sector-wide approaches (SWAps) and joint financing of more or less clearly delineated packages of interventions involving several donors (basket funding) to sectoral and general budget support with no specific earmarking of funds.

However, proponents of budget support as an aid instrument have argued in the past that it is the most appropriate modality to implement the principles of the Paris Agenda through PBAs. This view has been strongly opposed by critics, who stress the inherent risks associated with the instrument.

Chances and risks of budget support

Budget support, as the most extensive (but by no means the only) form of PBAs, is thus a response to the realisation that i) project-based aid has generated insufficient (systemic) effects; ii) substantially more funding is needed to reach the MDGs; and iii) good governance plays a key role for development processes no less than for the effectiveness of aid.

The main potential advantages of budget support and other forms of PBAs are seen in (i) lower recipient transaction costs; (ii) a strengthened policy dialogue between donors and partner governments – together with better political leverage when it comes to bringing about improvements in transparency, effectiveness, and corruption control in the administration of public funds; (iii) improvement of the predictability of, and thus also the ability of recipient governments to plan aid resources; (iv) improved donor coordination; (v) promotion of partner government ownership and accountability.

However, the risks associated with budget support routinely figure much more prominently in the public budget-support discussion than the benefits expected of the instrument.

These concerns centre on the so-called fiduciary risks, that is, the possibility that the funds provided may be used inefficiently or for other purposes than those intended by donors.

The most obvious argument against budget support in this context is the allegedly high risk that the funds involved could be misappropriated due to corruption. The instrument's advocates counter that it is only due to budget support that donors have come to pay more attention to corruption risks in public financial management as one key impediment to governments' capabilities of implementing public and private sector reforms and national development strategies. More importantly, it is only by providing funds through the recipient country's own financial management systems that donors can claim a legitimate and indisputable interest in identifying and addressing these risks. Compared to corruption control in stand-alone donor projects, mitigating the corruption risk for budget support funds requires that much more systemic issues are addressed by means of targeted conditionalities and safeguard mechanisms. Unlike projects, whose corruption-control measures in most cases are necessarily restricted to the project funds, the anti-corruption reforms and safeguard measures agreed in the framework of a high level budget support policy dialogue, and backed by appropriate conditionalities, can be expected to have positive effects on the recipient country's budget as a whole, including the domestically and otherwise funded share of the public budget.

However, aside from the possibility that funds could be wilfully misappropriated by corrupt government officials, budget support also includes the fiduciary risk that funds could be misused, completely legally, by the recipient government. This risk is rooted in the fungibility of budget funds, which makes it impossible to effectively earmark budget support exclusively for poverty-oriented expenditure.

One fact that is often overlooked in this argument is that ultimately all aid resources, including project funds, are fungible and can be used for purposes others than those intended, at least when there is a minimal degree of ownership by the recipients for the funded activities and projects (where there is not, the intervention will in most cases be unsustainable). The reason is that any such resources open up additional financial scope for recipient governments to put their own resources to alternative uses. It is therefore argued that it is only the policy dialogue conducted in the framework of budget support, in connection with appropriate conditionalities, that permits the donors to explicitly address, and to influence, the allocation decisions taken by recipient governments.

Furthermore, it is argued that the improved transparency in budgeting and public financial management brought about by budget support serves to strengthen the participation and oversight functions of both parliament and civil society, and thus additionally reduces the fiduciary risks affecting aid resources. This position appears to be backed by experiences made thus far with the instrument (IDD et al. 2006 and others), which seem to indicate that the policy dialogue and conditionalities involved have, in most cases, tended to improve the transparency of public financial management and strengthened the control rights of parliaments and the participation of civil society in the budget process.

A different risk frequently claimed in this respect, namely that efforts to improve the accountability of recipient governments towards external donors may serve at the same time to weaken internal accountability vis-à-vis the parliaments and citizens of partner countries, seems less significant in practice.

A further potential risk often pointed to in connection with budget support is that it may lead to a concentration of power at the central government level, in particular with the finance ministry. Advocates of budget support counter that one of the instrument's objectives is precisely to strengthen democratically legitimised government structures and reduce parallel structures often established by traditional forms of aid that can undermine the central government in its core functions and responsibilities. From this perspective, a strengthened role for the finance ministry in allocation decisions must be seen as a positive development.

The point here is not by any means to play down the risks associated with budget support. In fact, public financial management systems, public procurement, and the external budget oversight exercised by audit institutions and parliaments in virtually all potential recipient countries are in need of substantial reform.

These risks also need to be viewed in light of the substantial opportunities that the instrument – at least in principle – seems to entail. The crucial consideration here is that as a rule the risks associated with budget support constitute systemic development risks in the recipient countries, which are not only relevant for this particular aid modality. They also have implications for the development potentials and sustainability of other forms of aid and development efforts undertaken by partner countries themselves.

This is why it is unrealistic to seek to circumvent these risks through project-based aid. Indeed, the concern must be to assess risks realistically, on a case-by-case basis, and to identify adequate measures for mitigating them. Here, budget support offers a number entry points. What is more, the general risks and challenges bound up with development cooperation are often more clearly visible when it comes to budget support than they are with other approaches, even though they might be no less relevant for the long-term effectiveness of these other forms of aid.

The “standard model” of budget support

In view of the risks involved, most bilateral donors agree that, in principle, only a relatively small group of developing countries qualify to receive budget support. It is generally agreed that the most important preconditions for the instrument’s effectiveness are (i) a level of dependence on aid funds sufficient to ensure that donors have the leverage they need to push for improvements in governance and policy decision-making, (ii) a minimum of democratic structures and democratic government legitimacy, (iii) a minimum of transparency and effectiveness when it comes to public budget management, and (iv) a consistent development orientation and will to reform on the part of the recipient government. For these reasons, budget support is – with the exception of a few countries in Asia and Latin America – an option primarily for dynamic, reform-minded low-income countries in sub-Saharan Africa.

Donors differ in part substantially in terms of selection of countries and programme formulation. On the one hand, this may be due to different priorities for the use of the instrument (e.g. promotion of good governance vs. MDG financing). On the other hand, donors often differ in their approaches to analysing the chances and risks involved and may come to different assessments of what constitutes a sufficient level of good governance. Still, most budget-support projects do have a number of central points in common, and these may be regarded as the “standard model” of budget support in low-income countries.

The sine qua non for budget support is a national development or poverty reduction strategy (PRS) that is implemented through the recipient country’s national budget. In cases where budget support is provided by several donors, they usually form special budget-support donor groups to coordinate the policy dialogue with the recipient government, their assessments of the recipient government’s effectiveness, and the conditions that need to be in place for a disbursement of the funds (although coordination on this point is not always sufficient). One or more donors chair the group on a rotation basis. As a rule the dialogue on sector-specific issues is conducted in special sector working groups, with the recipient government and donors with specific sector interests discussing policies and programmes for the sector in question.

The recipient government’s performance in implementing the policies and conditions agreed upon is then regularly assessed on the basis of previously negotiated performance assessment frameworks (PAF) based on indicators derived from the country’s PRS. Aside from performance indicators designed to assess the implementation of the sector policies set out in the PRS, the PAFs always include indicators keyed to the transparency and effectiveness of public financial management as well as to other governance issues such as decentralisation.

Donors are called upon to make reliable commitments timed to coincide with the recipient government’s national planning and budget processes. Commitments are increasingly made on a multi-year basis and donors are expected to disburse their contributions in keeping with these data in order to ensure that the national PRS is financed on a continuous and predicable basis.

Budget support in Germany’s development cooperation

From the very outset, budget support has met with considerable scepticism by many actors in Germany. The debate was complicated by the fact that it could not be led in isolation from the institutional self-interests of the aid agencies involved. On the contrary, the debate on aid modalities was always perceived to be closely connected to a wider discussion on the reorganisation of the institutional setup of the German aid system, especially efforts to better integrate technical and financial cooperation.

A case in point of the general scepticism was the decision taken in 2007 by the German Bundestag’s Budget Committee instructing the Federal Audit Office (Bundesrechnungshof - BRH) to assess the use of budget support in German development cooperation.

The BRH report delivered in February 2008 did not fundamentally question the use of budget support as such, but called for caution and for better parliamentary oversight of its use. In 2009 the Budget Committee acted on this recommendation by reserving for itself the right to approve all programme-oriented joint financing (*Programmorientierte Gemeinschaftsfinanzierung* - PGF) proposals, including budget support, on a case-by-case basis.

According to the Federal Ministry for Economic Cooperation and Development (BMZ, 2008), German development cooperation pursues three objectives with its budget support to partner countries: (i) a governance objective, with the aim of contributing to effective and sustainable public institution building; (ii) an effectiveness and efficiency objective, to facilitate consistent implementation of the principles enshrined in the Paris Declaration; and (iii) a financing objective, to contribute to the attainment of the partner country’s development objectives by providing financial resources.

Partner countries eligible for German budget support are “*low income countries with dynamic reform processes*”. The selection of partner countries is based on an analysis of the political, fiduciary, and macroeconomic environment. In principle, only countries that demonstrate medium standards of governance in all assessed criteria and show a positive development trend are eligible for budget support, although deviation from these criteria may be considered in specific cases for fragile states or countries with conflict or other crisis potential.

Box 1 Relevance of budget support in German aid

In 2008, German budget support amounted to € 61.5 million, accounting for 2.5 % of new bilateral commitments (3.7 % of financial cooperation) in that year, compared to 5.8 % (8.9 % of financial cooperation) in 2007. Planning for 2009 provided for € 229.04 million in budget support (7.88 % of overall DC, or 11.5 % of financial cooperation). What appears to reflect a considerable expansion of the use of the instrument in 2009 over 2008 has in fact more to do with the accumulation of intergovernmental negotiations in the course of 2009. Between 2008 and 2009, 11 countries have received (or are set to receive) commitments for budget support (general and sector budget support). Alongside Burkina Faso, Ghana, Malawi, Mali, Mozambique, Rwanda, Zambia, Tanzania, and Uganda, these include Peru (sector budget support for urban water management) and Ethiopia (joint subnational-level programme to ensure the provision of basic social services).

Source: BMZ

Germany’s budget support contributions are prepared and implemented by the KfW development bank. For its evaluation of fiduciary risks BMZ also relies on country risk assessments prepared by KfW on the basis of the partner country’s public financial management system’s performance in the areas (i) institutional and legal framework, (ii) corruption, (iii) government effectiveness, (iv) own revenues, (v) parliamentary participation in the budget appropriation process, (vi) procurement; (vii) budgetary control, and (viii) willingness to reform and reform agenda. For its risk assessment, KfW makes use of both quantitative indicators (e.g. the World Banks’ World Governance Indicators) as well as qualitative assessments of the willingness to reform and reform agenda of recipient governments.

German involvement in budget support operations is regularly flanked by capacity building and other measures, including programmes designed to strengthen the institutional structure of partner national audit institutions.

An effective aid instrument?

Early studies on the effectiveness of budget support concluded that the instrument has positive effects on donor harmonisation, partner orientation, policy formulation, and the allocation and efficiency of public expenditure and the quality of public budget management (IDD et al. 2006). At the same time, the instrument tends to substantially increase the transaction costs of development cooperation, at least on the donor side, although it should be noted that it is not always easy to distinguish conceptually between unproductive transaction costs and investments needed for donor harmonisation, policy dialogue, and performance assessment. For example, aggregation of the various donor preferences in the performance assessment indicators often involves conflicts and extensive negotiations among donors. Yet, not addressing conceptual and strategic differences between donors active in the same sectors in a given country would arguably impact negatively on any form of aid.

However, even when donor harmonization works well and the recipient government shows credible will to implement agreed reforms, it often lacks the necessary capacities. Therefore, aid practitioners largely agree that while budget support may represent an effective instrument to promote donor coordination, provide necessary funding and create incentives for recipient governments to implement required reforms and expenditure programmes, in virtually all cases budget support needs to be applied in conjunction with other instruments – including interventions suited to building capacities – if it is to fully develop its potential impacts.

Little evidence has been presented thus far on positive poverty effects of budget support. One reason for this is that the instrument is still relatively new, and its intended effects on poverty reduction and growth are likely to materialize only over the medium to long term. Above all, it is difficult to clearly attribute development results to individual financing contributions or other inputs such as policy dialogue or conditionality in the framework of budget support.

Accordingly, there is at present also very little evidence available on the different impacts of different designs of budget-support operations with regard to country selection, the structure and content of the policy dialogue, or disbursement conditionalities.

Evaluating the effectiveness of budget support poses significant conceptual and methodological challenges. The main weakness of past attempts to evaluate budget support is that they fail to fully capture the long and complex causal chains of the (often not explicitly formulated) intervention logic of budget support. The substantial heterogeneity of the interventions involved in budget support programmes (financing, policy dialogue, conditionality) has not been adequately accounted for.

Ongoing attempts to evaluate budget support therefore seek to systematically interlink assessments of the macro-economic impacts, the political economy of policy dialogue and performance assessments, and the ultimate impact of government policies by combining various quantitative and qualitative methods at the different impact levels involved.

New challenges in dealing with budget support

Apart from the fundamental problem of evaluation, increasingly new challenges are also emerging with regard to the effective use of budget support, which have to do less with the instrument's risks than with its potential benefits.

It is increasingly discussed whether budget support might not also be suited to financing other tasks in developing countries than poverty reduction strategies, including efforts to adapt to climate change or to cope with the current economic and financial crisis. In terms of the financial resources thought to be required, these tasks not only resemble efforts to reach the MDGs, they also call for similarly comprehensive national strategies that need to be implemented through national structures and processes.

However, alongside the advantage of being able to fall back on a fairly well-established instrument when it comes to handling large volumes of funds, any such expansion would also imply risks for the effectiveness of budget support as aid instrument.

In one sense it would, in the short to medium term, be likely to overstrain the absorption capacity of many developing countries. In another, any major increase in funding volumes would be likely to further increase the disbursement pressure, in particular on multilateral donors. This, though, would add to the difficulties involved in formulating exacting and at the same time realistic conditions for the provision of budget support. Thirdly, it would involve a risk that the donor-recipient policy dialogue, already quite diverse and multifaceted, might be overloaded with additional topics and issues; one possible outcome would be an overly complex planning apparatus with little policy effectiveness as well as the risk of crowding out core issues such as good governance and poverty reduction.

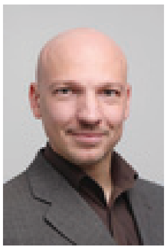
Conclusion

Budget support is by now a fairly well-established instrument of international development cooperation, though one whose ultimate poverty effects are yet to be demonstrated. In doing so, the instrument's important potential development-related benefits need to be weighed off against its possible serious risks.

Germany has thus far been comparatively hesitant to commit significant amounts of its aid budget to this relatively new aid modality. Yet, if Germany is to heed its commitment to increase the effectiveness of its aid, it will have to take seriously the Paris Declaration's target of providing, by 2010, 66 % of its aid in the form of PBAs (not only budget support!).

But the only way to reach this goal is for development cooperation to continue to seek to create the conditions required for an effective use of budget support and other forms of PBAs. This would also include a better understanding of these conditions themselves. German development cooperation would therefore be well advised to continue its efforts to participate in the development and application of adequate evaluation methods for budget support. Important first steps in this direction have already been taken.

It is at the same time important to ensure that the instrument's potential effectiveness is not undermined by overloading it with new issues and financial resources. This calls for a strong engagement of the German Government in the relevant multilateral fora with a view to ensuring that (development) policy coherence is not compromised if budget support is used for purposes other than reaching the MDGs.



Stefan Leiderer
Research fellow, DIE

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DEUTSCHES INSTITUT FÜR ENTWICKLUNGSPOLITIK · GERMAN DEVELOPMENT INSTITUTE gGmbH©
Tulpenfeld 6, 53113 Bonn ☏ +49 (0)228 94927-0 🖷 +49 (0)228 94927-130
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