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**GREEN PAPER FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN
PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND
THE COMMITTEE OF THE REGIONS**

The future of EU budget support to third countries

1. INTRODUCTION

The Millennium Development Goals (MDGs) set in 2000 galvanised international support for development and triggered other initiatives to increase the volume and effectiveness of aid, based on a sound partnership between donors and partner countries. The Monterrey Consensus (2002), the European Consensus on Development (2005), the Paris Declaration on Aid Effectiveness (2005) and the Accra Agenda for Action (2008) were key milestones in this process, establishing the five key principles of ownership, harmonisation, alignment, managing for results and mutual accountability.

In 2000, the Commission presented a Communication on budget support: ‘Community support for economic reform programmes and structural adjustment: review and prospects’¹. This helped to shape the design of budget support for the following decade. With five years to go before the 2015 MDG deadline, budget support has become an increasingly prominent element of the aid effectiveness agenda. Over the period 2003-2009, the European Commission made budget support commitments totalling over €13bn (about 25% of all commitments in this period). About 56% of commitments were made in Africa, Caribbean and Pacific (ACP) countries, 24% in neighbourhood countries, 8% in Asia, 6% in Latin America and 5% in South Africa.

However, questions about the quality, value for money and impact of budget support are increasingly being raised by a range of stakeholders, including the European Court of Auditors, European and national Parliaments and civil society. These need to be answered as the Commission works to improve its approach to budget support. Key issues include i) political governance and the role of political dialogue; ii) the role of policy dialogue, role of conditionality, and links to performance and results; iii) domestic and mutual accountability; iv) programming of budget support and its coherence with other instruments; v) strengthening risk assessment and dealing with fraud and corruption; vi) budget support in situations of fragility; and vii) growth, fiscal policy and mobilisation of domestic revenues. Improved coordination across the EU is also essential, as the Lisbon Treaty and the establishment of the European External Action Service are changing the EU institutional context in which budget support is provided.

The **purpose** of this Green Paper is to gather views from stakeholders regarding the objectives and use of EU budget support, building on the joint experience of the last 10 years, while recognising differences in the context and nature of EU cooperation with different regions and countries. The **specific objectives** of the Green Paper are to identify opportunities and challenges, to raise specific questions on how these opportunities can be exploited and challenges addressed, and to collect views and evidence that will improve our approach to budget support.

The bulk of EU budget support is provided to developing countries and particular emphasis is therefore given to development cooperation. But the **scope** of this paper covers EU budget support to all regions, taking account of differences between developing countries, and also differences with EU candidate countries and potential candidates, and neighbouring countries in which European cooperation and partnership are intended to support reform and transition to enable closer political association and gradual economic integration. The issues raised in

¹ COM(2000)58 of 04/02/2000.

this paper will therefore have different relevance and may generate different answers for different regions.

Section 2 defines budget support. Section 3 reviews experience and identifies a number of key principles for the design and implementation of budget support. Section 4 sets out a number of more contentious issues that form the bulk of this consultation document. Section 5 concludes. Supporting background documents can be found at [*insert website address*].

This Green Paper will be published on the Commission's website (<http://ec.europa.eu/yourvoice/>). The consultation will run from 19 October to end December 2010 and is open to any interested stakeholder. Individuals, organisations and countries are invited to send their contributions, in the form of answers to the questions presented in the document and/or as general comments on the issues raised. Contributions received will be published, possibly in a summarised form, unless the author objects to publication of their personal data on the grounds that such publication would harm his/her legitimate interests. In this case, the contribution may be published in anonymous form. Otherwise, the contribution will not be published nor, in principle, will its content be taken into account. Furthermore, since the launch in June 2008 of the Register for Interest Representatives (lobbyists) as part of the European Transparency Initiative, organisations are invited to use this Register to provide the European Commission and the public at large with information about their objectives, funding and structures. It is Commission policy that submissions from organisations will be considered as individual contributions unless the organisations have registered

Contributions should be sent to DEV-BSGP@ec.europa.eu. Enquiries about this consultation can be sent to the same mailbox, or to the European Commission, DG Development, Unit C/3, Office SC-15 05/100, 1049 Brussels, Belgium.

2. WHAT IS BUDGET SUPPORT?

Budget support is part of an overall country cooperation package. It involves policy dialogue, financial transfers, performance assessment and capacity-building, based on partnership and mutual accountability.

Box 1: Definition of budget support:

Budget support is the **transfer of financial resources** of an external financing agency to the National Treasury of a partner country, following the respect by the latter of agreed **conditions** for payment. The financial resources thus received are part of the global resources of the partner country, and consequently used in accordance with the public financial management system of the partner country.

The EU only provides budget support to countries that meet the following three **eligibility criteria**, derived from the legal frameworks governing EU support to each region: when there is in place or under implementation a) a well defined national (or sectoral in the case of SBS) policy and strategy; b) a stability-oriented macroeconomic framework; c) a credible and relevant programme to improve public financial management. All disbursements are conditional on continued adherence to these three standard eligibility criteria (reflected in the "**general conditions**"), and may also be subject to "**specific conditions**" reflecting performance criteria and indicators (often focused on results) in priority areas.

Through budget support, donors help partner governments finance key government functions, such as building schools and hospitals, paying for teachers and health care staff, building

infrastructure, improving security and the rule of law, implementing complex reform processes and achieving macroeconomic stability.

Budget support is meant to overcome weaknesses of the traditional project approach (high transaction costs, fragmented parallel systems) that, particularly in heavily aid-dependent countries, inhibited the development of coherent policies by partner governments, further weakened the limited capacity of national institutions, and undermined the sustainability of aid. In contrast, budget support is seen as a means of fostering partner countries' ownership of development policies and reform processes, strengthening national accountability institutions and systems, and facilitating growth, poverty reduction and the achievement of development objectives.

EU budget support is not a blank cheque, nor is it provided to every country. 'Underlying principles' matter (see section 4.1), and policy dialogue is a central part of the package. Moreover, eligibility criteria (see Box 1) have to be met and conditions fulfilled in order to help safeguard the use of resources, mitigate risks, and create incentives for improved performance. Budget support has evolved significantly over time, with different orientations in different regions.

The European Court of Auditors has been instrumental in helping the Commission to improve its approach to budget support (see Box 2). In its most recent discussions with the Commission, the Court acknowledges progress, but identifies weaknesses that may still prevent general budget support from achieving its full potential. It recommends a clearer definition of country-specific objectives to facilitate the assessment of impact; the use of a complete risk management framework to mitigate financial management and development risks; more transparency and a rationale for allocations to budget support and to fixed and variable tranches; strengthened management of performance-related conditionality and policy dialogue; and more regular reporting on performance, covering benefits as well as risks. These points, together with internal audit and the European Parliament's recommendations, are critical in helping to inform the EU's approach to budget support in future.

Box 2: Budget support and the European Court of Auditors

The Court of Auditors regularly scrutinises EU budget support in its annual reports. It has issued two relevant special reports related to general budget support and intends to publish a third by end 2010. Court recommendations have informed revisions and improvements the Commission has made to its approach and guidelines. Specifically, the Court has contributed to the transition from targeted to untargeted budget support (SR 5/2001), and encouraged the development and use of a common public financial management performance measurement framework as well as stronger coordination and joint assessments with donors' local representatives (SR 2/2005). The Court has repeatedly assessed the dynamic interpretation of eligibility applied by the Commission and has insisted that the Commission should demonstrate eligibility and performance in public financial management in a more explicit, formalised and structured manner (SR 2/2005, AR 2009). The Court has also produced a special report on EU assistance to the health sector. This concluded that general budget support had not yet made an effective contribution to improving health services and should focus more on doing so, while the use of focused sector budget support should increase (SR 10/2008). The Court also intends to publish a special report on the education sector.

In this paper, 'EU budget support' refers to budget support managed by the European Commission, originating from the External Action Instruments financed by the EU Budget as well as support financed by the European Development Fund. It may take the form of **general**

budget support (GBS) to support a country's national development strategy, or **sector budget support (SBS)** to support a particular sector strategy. The EU and other budget support donors increasingly use general and sector budget support alongside each other and there is growing interest in using budget support for new and specific issues (such as climate change). While SBS is provided by the EU and some other donors in its untargeted form, others apply some form of earmarking of funds.

GBS and SBS have **different objectives** which will be reflected in the conditions and dialogue. GBS aims to support a national development policy and strategy and has the potential to address the full range of policies and reforms; SBS aims at supporting a sector policy and reform agenda and has the attraction of being more focused on key sectors of interest. SBS has particular added value where budget support represents a small share of the national budget, and where more focused policy dialogue and reforms within a sector is sought. In many cases the EU uses both modalities in tandem, particularly in African, Caribbean and Pacific countries, with SBS complementing GBS by making national development policy more responsive to the specific needs of a particular sector or reform.

Coordination is key. The EU is a major provider of budget support. Work is underway to further improve coordination regarding policy dialogue and political dialogue, programme design and implementation, promoting domestic and mutual accountability, and conducting and communicating the results of evaluations. This work has also informed this Green Paper and will contribute to improving the effectiveness of budget support, as well as the coherence and credibility of EU donors, while improving coordination among all providers of budget support.

Box 3: Evolution of EU Budget Support

Early experience with budget support in the 1990s showed the limits of conditionality as an effective means of promoting reforms; the importance of partner countries owning policies; and the limited effect of targeting funds to specific budget lines. Building on this experience, the Commission adopted a **Communication** (2000) on 'Community support for economic reform programmes and structural adjustment: review and prospects' which introduced poverty reduction budget support (PRBS) and an innovative approach to conditionality. This Communication set objectives for budget support that later became part of the aid effectiveness principles.

EU budget support programmes were increasingly provided over three-year periods with **annual fixed tranches** subject to compliance with eligibility criteria, and **variable tranches** linked also to performance against agreed targets on selected outcome indicators, mainly in social sectors.

Regarding **eligibility criteria** for budget support, the Commission (along with most other providers) applies a dynamic approach by requiring relevant, credible commitment to reform and evidence of progress rather than compliance with minimum standards. This approach has allowed the Commission to operate in very diverse contexts, including in **countries in situation of fragility**, where budget support can underpin stabilisation and avoid deterioration of the economic and political situation.

In 2008, the Commission also launched '**MDG Contracts**' for countries with a track record of successfully managing budget support, and demonstrating commitment to making progress towards the Millennium Development Goals (MDGs). MDG Contracts provide six-year commitments that enable governments to plan longer-term strategies and budgets with greater certainty about future resource inflows.

3. BUDGET SUPPORT GOING FORWARD — SOME KEY PRINCIPLES

Budget support has evolved over the past decade and a number of lessons regarding its design and impact have been learned (see Boxes 3 and 4).

Box 4: Budget Support — Lessons Learned

A major 2006 **evaluation** of general budget support (GBS) in seven developing countries (Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Uganda, and Vietnam) commissioned by the Organisation for Economic Cooperation and Development's Development Assistance Committee (OECD-DAC) concluded that budget support had been a relevant response to acknowledged problems in aid effectiveness, and can be an efficient, effective and sustainable way of supporting national poverty reduction strategies. It found that GBS had positive effects on harmonisation and alignment, and on strengthening government ownership and accountability. It also had positive effects on the efficiency of public expenditure, and on government capacity, particularly in public finance management. Budget support had also led to improvements in access to services in most countries. There was no evidence of significant crowding out of private investment or of undermining domestic revenue effort, nor any clear evidence that budget support funds were more affected by corruption than other forms of aid. However, the evaluation expressed reservations about impacts on poverty reduction and the quality of basic services. A revised evaluation methodology is currently being piloted in Mali, Tunisia and Zambia. Recent **independent evaluations of European Commission country programmes** in 20 countries where budget support has been a significant feature have generally confirmed its relevance, and recommended its continuation. But in general, it has been difficult to assess the impact of budget support on poverty reduction and other MDG indicators. Questions of attribution, and also of assessing what might have been achieved with alternative instruments (the counterfactual), have proved particularly difficult.

These highlight that budget support should not be seen as an end in itself, but as a means of improving the effectiveness of aid and achieving results. And while the weight of each will differ between regions, a number of key principles can be identified to guide the design and implementation of budget support around which there is a high degree of consensus across EU budget support providers:

Budget support as part of a package: Budget support must be more than a financial transfer – it is part of a package including policy dialogue, performance assessment, capacity-building and other supporting interventions.

Ownership: Budget support should support a country in achieving its own development strategies.

Results: Budget support should focus on achieving measurable outcomes.

Predictability: Budget support should be provided in a way that ensures a high degree of predictability in both the short and long term.

Accountability: Budget support should be provided in a way that enhances the accountability of governments to their citizens, national parliaments and supreme audit institutions regarding the way resources are used and the results achieved (domestic accountability). Budget support should also be provided in a way that ensures that partner countries honour their commitments to donors *and* donors honour their commitments to partner countries (mutual accountability).

A more coordinated EU approach: EU budget support should be provided in a way that improves coordination both within and beyond the EU, and enhances the coherence and credibility of the EU.

Public support: To ensure public support from stakeholders within the EU, budget support needs to provide strong evidence of results achieved and progress made by partner countries. Citizens in partner countries should also be able to understand and identify the difference budget support makes in their countries.

4. BUDGET SUPPORT: KEY ISSUES

It is also evident that a number of challenges remain to improve the quality, value for money and impact of budget support. Key issues where there is less clarity or consensus on the best way forward are related to:

- Political governance and the role of political dialogue;
- Role of policy dialogue, role of conditionality, links to performance and results;
- Domestic and mutual accountability;
- Programming of budget support and its coherence with other instruments;
- Strengthening risk assessment and dealing with fraud and corruption;
- Budget support in situations of fragility;
- Growth, fiscal policy and mobilisation of domestic revenues.

These issues are presented in detail below, together with a number of questions to which stakeholders are invited to respond. Evidence and examples in support of responses are welcome.

4.1. Political governance and the role of political dialogue

Political governance has recently emerged as one of the most critical issues in budget support. At issue is whether budget support should be explicitly conditional on a country's respect of the underlying principles of human rights, democratic principles and the rule of law (see Box 5); or whether these should remain principles that underpin all cooperation and therefore apply to the entire partnership and all aid modalities.

OECD-DAC guidance suggests that 'political conditionality should not be specifically linked to budget support or any individual aid instrument, but rather should be handled in the context of the overarching political dialogue between a partner country and its donors'².

Ultimately, budget support can always be suspended (as can a project) if there is a serious breach of underlying principles. This is in line with the various EU instruments and

² DAC Guidelines on Harmonising Donors' Practices for Effective Aid, Budget support (vol 2, 2005).

agreements governing development and wider cooperation in all regions³, and necessary in order to maintain the legitimacy of budget support and of aid in general. Experience has shown that **political sensitivities** are likely to be more intense in the case of budget support, mainly in the context of general budget support (GBS), since it is widely seen as providing an endorsement of the partner country's overall policy stance. Sector budget support (SBS) is at times perceived as less vulnerable to political risk because it supports the implementation of a specific sector policy instead of the overall development policy of the partner country. Many donors have found that compared to GBS, SBS is easier to justify to taxpayers and parliaments at home in a context of political difficulties or growing corruption in the partner country.

Box 5: Underlying Principles

In this Green Paper, 'underlying principles' refer solely to political elements reflected in the EU Lisbon Treaty's general provisions on the Union's external action.

This states that: *'The Union's action on the international scene shall be guided by the principles which have inspired its own creation, development and enlargement, and which it seeks to advance in the wider world: democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity, and respect for the principles of the United Nations Charter and international law.'* (Article 21.1).

Recent political governance concerns in several developing countries receiving budget support have encouraged some donors to shift their attention to the underlying principles of human rights, democratic principles and rule of law, with budget support being used more explicitly to achieve broader political objectives. The intrinsically political nature of the national budget, and the closeness between dialogue on the overall policy priorities of the partner country and political dialogue, has raised two main issues.

The first issue concerns the provision of budget support when underlying principles deteriorate. Some donors suspend disbursements, while others continue. Such inconsistent responses can send the wrong message to the partner governments concerned. This highlights the need to find an approach that improves coherence and consistency, ensuring that underlying principles are shared and respected, while protecting the development benefits including predictability of budget support.

The second issue concerns the most appropriate forum for dialogue on political governance. Some have advocated using all possible avenues, including budget support dialogue processes, as a means of maximising leverage and influence on political issues regarding underlying principles. Others have favoured a more political forum, separate from but informing and informed by budget support dialogue processes, in recognition that these principles underpin all development cooperation.

Q1: Should budget support operations (especially general budget support) be designed to better reflect partner countries' commitment to the **underlying principles** and if so, how? In particular, should budget support programmes make more use of political governance conditionality? Is there a case for adopting a different approach to **political conditionality** for

³ Notably the Cotonou Agreement, the Development and Cooperation Instrument (DCI), the European Neighbourhood and Partnership Instrument (ENPI), and the Instrument for Pre-Accession Assistance (IPA).

general as opposed to sector budget support?

Q2: How can the budget support process be consistent with the **political dialogue** on underlying principles while maintaining the focus of **policy dialogue** on agreed development objectives? What could be the **relevant fora and the appropriate level** involving donors and partner country to raise and discuss concerns regarding underlying principles?

Q3: How can donors meaningfully **respond** to any deterioration in the underlying principles while protecting the development benefits and predictability of budget support?

4.2. Role of policy dialogue, role of conditionality and links to performance and results

Policy dialogue rooted in a partner country's own budgetary and policy processes is essential to ensure that the policy measures needed to achieve agreed targets are identified, discussed and fully resourced. Such dialogue helps to ensure a clearer link between the use of resources (including budget support) and achieving results, and much needs to be done to make it more effective. For instance, it is particularly important to ensure that supreme audit institutions, national parliaments, the private sector and civil society organisations become more involved.

Areas relevant for policy dialogue would include growth strategy; macroeconomic stability; fiscal policy (including domestic revenue generation and budget composition at central and decentralised levels); sector policies (especially social sectors); social protection (including use of conditional cash transfer schemes⁴); public financial management; broader governance issues such as the fight against corruption and fraud, public sector reform, including decentralisation. **Policy dialogue** is distinct from broader **political dialogue** on underlying principles, though they should of course complement and reinforce each other. The key issue is how to make this policy dialogue more effective. This raises issues about the scope of dialogue and the skills required; the role of conditionality; and the appropriate balance between policy reforms and result indicators in performance assessment frameworks and as disbursement triggers (see also Box 6).

Box 6: Budget support policy dialogue in different contexts

The objectives of budget support drive the scope and nature of policy dialogue in each country. These objectives and structure of dialogue will vary depending on country circumstances and level of development, the nature of its relationship with the EU and wider donor involvement. For instance, in an **Asian or Latin American** country, where aid and budget support typically represent a very small share of the national budget, dialogue may be very different to that in most **African** countries. In **small island states and Overseas Countries and Territories (OCTs)** some particular challenges may need to be addressed, such as small national administrations, absence of robust national policies and strategies, absence of independent macro-economic frameworks, and limited involvement of and coordination with other donors. In **EU neighbourhood and enlargement countries**, where EU policy is more focused on promoting EU-oriented reforms aimed at political association and economic integration, there is a stronger emphasis on holding partner countries accountable for specific policy measures to be implemented in the short term, such as adopting legislation harmonised with the EU *acquis* in the context of Stabilisation and Association Agreements in the case of potential candidates

⁴ Those schemes provide financial transfers to poor families on condition that their children attend school and have basic health care (e.g. Brazil, Mexico, Bangladesh).

and candidate countries, and in the context of Association Agreements currently being negotiated in the case of neighbourhood countries.

Effective policy dialogue requires skilled donor staff with the opportunity and ability to support both the analysis of problems that hamper progress towards agreed development objectives, and the identification and implementation of solutions. But many donors lack the right human resources to make the most of these opportunities. This may be partly addressed by more sharing of expertise and designing a more efficient division of labour between budget support providers, but it also requires renewed investment in appropriate skills.

Conditionality. Selecting countries for budget support on the basis of defined eligibility criteria is a legitimate application of conditionality. The Commission presently abstains from setting minimum requirements considering that commitments from a partner country to the reform process are more important. Disbursements may be conditional on a combination of policy measures and results achieved. The balance of evidence suggests that policy conditionality has rarely been effective in securing reforms unless there is a strong domestic constituency in favour. Many actors, including the European Commission, have placed more emphasis on results, although most programmes combine both policy and result indicators.

Performance and results. The European Commission has pioneered the use of outcome and result indicators in its budget support programmes as a basis for assessing progress and deciding the amount of variable tranche disbursements, and as a focus for policy dialogue⁵. This approach was intended to provide space to partner governments to set their own policies (in line with the principle of ownership), and to stimulate debate on how and why policies succeed in delivering results (or not). However, questions and challenges have emerged, regarding the capacity of statistical services to regularly produce, analyse and disseminate relevant, objective and good quality statistics to measure performance; the choice of indicators and targets; whether performance is best assessed by a narrow focus on those indicators or by a more holistic performance assessment; and more broadly, the extent to which countries find results-based conditionality an effective incentive to perform better.

A focus on results is central. But the financial attribution of budget support to specific results is more difficult than for projects, because budget support funds are absorbed into a country's overall budget and cannot be traced. And yet donors must account for the use of budget support, so it is important for the EU – and the European taxpayer – to have more clear evidence that partner countries spend resources as intended, obtain good value for money, and achieve the objectives agreed. This requires donors to focus analysis and policy dialogue on all major areas of the public financial management (PFM) system and the fiscal policy of a government, covering the whole budget cycle. Where weaknesses are identified, governments need to show they have a relevant and credible PFM reform programme, and to demonstrate progress over time. Better budget analysis is important to improve the performance of the financial management system and the benefits of budget support. Defining specific objectives, performance indicators and a monitoring framework to show how budget support contributes to development and poverty reduction remains a key challenge. In this context demand driven and result-oriented capacity development, in particular of line Ministries and control bodies such as the Supreme Audit Institutions and National Parliaments, is of paramount importance.

Q4: How can **policy dialogue** with partner countries be made more effective and inclusive in

⁵ The development by the Centre for Global Development of 'cash on delivery' approaches to paying for results and rewarding performance represents a further and more radical innovation in this direction.

contributing to achieving reforms, results and objectives?

Q5: How should donors use budget support **conditionality** to help improve performance, and how should they respond to failure to meet agreed conditions?

Q6: How can performance monitoring frameworks be improved and **result indicators** be best used in budget support operations in order to address the challenges identified above?

Q7: How can the performance of the **public financial management** system, including fraud prevention measures, and the **value for money** of budget support funds be best enhanced? Should the EU set minimum requirements for budget support?

4.3. Accountability

Domestic accountability refers to a partner government being accountable to its citizens and institutions (parliament, supreme audit institutions) on policy choices, revenue collections, budget allocations and outcomes. It is a two-way relationship. Citizens and institutions must also be able to hold their government accountable for its actions, to check abuses and to impose sanctions. The accountability of a partner government to its citizens is a key driver in achieving development outcomes. It is an important component of a **country's ownership** of its development agenda. Budget support is in principle subject to domestic parliamentary and audit scrutiny in a way that project support is often not.

However, there have to date been only modest improvements in domestic accountability, partly because changes take time to implement and to bring about results. The capacity of civil society and parliaments to advocate and monitor policy choices during a transparent budget process is still weak in many countries. Supporting national accountability institutions and systems is a major challenge for donors involved in budget support. Donors' demands may overshadow domestic accountability by imposing an externally-driven agenda, particularly when the amount of budget support is significant relative to the national budget.

Mutual accountability. From the **donors' perspective**, mutual accountability is important so that donor governments can demonstrate to their parliamentarians and tax payers that they are using public funds allocated for development assistance effectively. From the **partner countries' perspective**, they need credible donor commitments to provide timely, predictable, transparent and comprehensive information on aid flows (especially budget support), aligned with the budget cycle, to prepare and implement comprehensive budgets that deliver agreed policy objectives and priorities. Partner countries also need to inform the general public about their relationship with the donor community and the benefits of budget support. However civil society can only scrutinise government action where it has key information on amounts spent for specific measures and where channels to inform appropriate authorities, including donors, about fraud and corruption exist.

Q8: How can budget support (including capacity building) be designed to further enhance **domestic accountability** and ownership in partner countries, including the participation of civil society?

Q9: How can **mutual accountability** better contribute to enhancing effectiveness of budget support operations in both donor and partner countries?

Q10: What kind of visibility/communication activities should be carried out both in donor and partner countries to enhance mutual accountability?

4.4. Programming of budget support and its coherence with other instruments

The decision on whether and how much budget support to provide needs to be seen in the wider context of aid programming as a whole, in which country allocations are determined by a combination of needs and performance. It relates to a broader political economy analysis, each country's financing needs (considering its medium-term fiscal framework and the contribution that donors and creditors can propose), absorptive capacity, and risks and expected benefits of budget support. Once the country context has been adequately analysed, including government efforts to address identified weaknesses and available domestic resources, the objectives of the cooperation and the most appropriate aid modality - which should also take questions of unit costs and value for money into account - can be decided accordingly.

Several other modalities coexist with budget support, including vertical funds, multi-donor trust funds (MDTFs), pooled funds, and project aid. A wide range of implementation modalities is considered an advantage to respond to different needs and objectives in different contexts. In some areas, such as support for Non State Actors or for electoral processes, it is evident that this cannot and should not be provided as budget support. For others, such as high high-level expertise or major infrastructure investments, it would have to be decided within the country context what modality is the most appropriate.

Regarding General budget support (GBS) and Sector budget support (SBS), a key question is whether budget support to a particular country should focus on a wider range of areas (GBS) to get a broad picture of the national policy but at the cost of being potentially less effective on sector policy dialogue; or focus on specific sectors (SBS) for more effective policy dialogue, but at the cost of potentially neglecting wider, cross-sector reform issues necessary for progress to be made at sector level. In many cases the EU uses both modalities in tandem (see section 2).

Q11: What criteria should the Commission use to inform decisions on **how much** if any budget support to provide to eligible countries?

Q12: What are the advantages and disadvantages of providing both **general and sector budget support** within the same country, or having one single budget support instrument? In which context would SBS be considered a more effective type of budget support?

Q13: What are the advantages and disadvantages, as well as the practical arrangements to ensure consistency and efficient coordination, of using a broad palette of aid instruments alongside GBS/SBS?

4.5. Strengthening risk assessment and dealing with fraud and corruption

The efficiency and impact of all forms of aid (from project aid to budget support) may be undermined by a number of risks that must be mitigated. Budget support and project aid have

different risk profiles; this implies that risk management must be adapted to the aid delivery method selected. The risk management framework for **budget support** is an important tool in the assessment of eligibility, in programming, design and implementation of programmes and to inform policy dialogue. It is an instrument to protect the financial interests of the EU. It is also a crucial dimension of the dynamic approach to eligibility (see Box 1) that requires credible commitment to relevant reforms and evidence of progress. In this context it is important to review and strengthen risk management approaches for budget support.

A serious deterioration of **political governance** in a partner country receiving budget support, could significantly reduce the role of the national budget as expression of the common interest, and undermine accountability mechanisms. This could in turn undermine budget support efforts to improve the transparency and the management of the budget itself and ultimately erode budget support effectiveness. Assessing political risks requires an intensified political dialogue that covers aspects relevant for budget support.

Managing macro-economic and development risks requires strong monitoring processes, relevant diagnostics and indicators, and the capacity to identify and adopt corrective measures when appropriate. The limited quality and availability of relevant indicators complicates managing these risks. Improving the scope and quality of dialogue on progress in implementing national and sector policies is vital for effective risk management.

Improving tools for managing **financial risk** is essential. In all budget support operations donor funds are managed according to the partner country's public financial management and control systems and procedures (see Box 1). Financial risk is assessed and mitigated through progress in the efficiency and effectiveness of **public financial management**. Regular diagnostics can identify key areas of progress and weakness and inform the preparation and implementation of reform programmes whose relevance and credibility is monitored through budget support processes.

Corruption is a serious threat to development efforts. It undermines democracy and good governance by subverting formal and institutional processes. Corruption undermines economic development by diverting resources from priority expenditures, generating inefficiency and lack of compliance with procurement procedures in public service delivery. Corruption is one of the key factors that affect the balance of arguments for and against budget support. Failure to tackle corruption undermines confidence in both the budget and the wider political economy, and has **implications for both financial and development risks**. In addition as donor funds are merged with the national budget, fraud or corruption allegations are not brought to the attention or investigated by the Commission. And in cases of misappropriation of partner countries' budget resources recovery of funds may prove difficult. It is therefore essential that close dialogue with the partner governments on corruption issues is maintained by the Commission and the donor community at large.

External risk factors, such as adverse international financial and economic factors, volatility in commodity prices, or climate conditions, can also affect the budget situation of a partner country. The recent global financial and economic crisis has shown how interconnected the world is. Monitoring and mitigating external risks requires measures to increase the resilience of the budget, including the tax structure, to external shocks.

Q14: How can the above **risks** be best assessed within a **comprehensive framework and managed** to improve the effectiveness of budget support?

Q15: What kind of measures should the EU apply if the risk level is considered high with regard to fraud and corruption?

Q16: How can donors meaningfully respond, including with financial corrective measures, to cases of large scale corruption or fraud in the implementation of policies benefiting from budget support?

4.6. Budget support in situations of fragility

Budget support may be critical in helping to provide a degree of economic and political stability to countries in situations of fragility.

Box 7: Situations of fragility.

This is a situation where the social contract is broken due to the State's incapacity or inability to deal with its basic functions, and meet its obligations regarding: service delivery, management of resources, rule of law, equitable access to power, security and safety of the populace and protection and promotion of citizens' rights and freedoms. Broadly speaking, a country's emergence from crisis comprises three successive phases, which often overlap, in which the political partners and donors intervene: The emergency phase that is followed by the peace-building stage, which encompasses social and economic rehabilitation and the start of institutional rebuilding. The third stage is macroeconomic stabilisation (generally marked by the resumption of aid from the IFIs once arrears have been cleared), which leads to development. Each phase as the country emerges from crisis offers a window of opportunity for deciding whether to grant budget support.

While the risks are by definition high, the costs of non-intervention, and the benefits (e.g. maintaining basic state functions like service delivery and security) of effective support, may be higher still. Eligibility criteria need to be interpreted to reflect the partner country's actual capacity, commitment, and progress potential. But stronger coordination among those donors ready to support the re-establishment of the state is essential to ensuring a proper and continuous assessment and management of risks, rigorous monitoring of progress, and responsiveness in design. The Commission is working on a 'common approach paper' with the IMF, World Bank, and African Development Bank. Nevertheless, relatively few bilateral donors currently provide budget support to countries in situation of fragility.

Q17: Should budget support be used to promote stability in **fragile states**, and if so, how?

4.7. Growth, fiscal policy and mobilisation of domestic revenues

Both partner country development strategies and EU attention are increasingly focusing on the importance of sustainable **economic growth**, in addition to the delivery of social services. It is consequently necessary to ensure that development aid in general, and budget support in particular, is also able to stimulate and contribute to inclusive growth and sustainable development as well as poverty reduction. More attention will need to be given in particular to the identification of steps needed to remove binding constraints to sustained growth, such as inadequate economic infrastructure, red tape or limited human capital. Budget support can

contribute through promoting macroeconomic stability, key reforms for an economic environment more conducive to business, and more efficient budget allocation. Fiscal policy is a particularly important subject for budget support policy dialogue.

Securing domestic revenue is crucial to ensure macroeconomic stability, to achieve and sustain development objectives, to reduce poverty, to meet MDG targets, and to strengthen domestic accountability. It relates both to economic growth in partner countries and to tax systems. Improving developing countries' capacity to raise revenues in line with the principles of good governance (transparency, exchange of information and fair tax competition) will in the long term help developing countries to reduce their dependency on aid and to consider an eventual **exit strategy** from budget support, with the place of budget support likely to change as countries become less aid dependent. Partner countries should be committed to strengthening their domestic tax systems and collection rates.

A broad tax base combined with effective revenue and expenditure management increases the legitimacy of the state and reinforces the relationship between government and citizen. Part of the objective of budget support programmes should be to assist the recipient country's capacity to address domestic and international challenges of revenue collection, in order to improve accountability and self-reliance and to reduce long-term dependency. Although some budget support programmes do address revenue questions, the main focus of dialogue and conditionality in budget support programmes has been on improving the management of public expenditure. There is therefore scope to focus more directly on domestic revenue issues and good governance in the tax area in budget support dialogue, conditionality, performance assessment and capacity development (noting also the particular revenue challenges in natural resource-rich countries). This would progressively allow improving references and compliance with the principles of good governance in the tax area (i.e. transparency, exchange of information and fair tax competition). The issue of whether budget support should be conditional on reforms and good governance in the area of tax is particularly relevant.

Supporting **regional integration** is also a key feature in EU cooperation. Regional integration brings significant economic benefits, but also new challenges, in particular the need to shift the revenue base from external tariffs towards internal taxation as trade liberalisation may result in a continued decrease in customs revenue.

Q18: How can budget support programmes be designed and implemented to best promote **inclusive and sustained growth**?

Q19: How can budget support policy dialogue and conditionality promote more **domestic revenue generation** and **terminate dependency on aid**? What form of an exit strategy should donors include in their budget support operations, and how to arrange it?

Q20: How can budget support be used to assist partner countries and regional organisations to further the process of **regional integration**?

5. CONCLUSIONS AND NEXT STEPS

Budget support has been seen as a solution to the question of how to make more effective use of aid, but it is not without challenges of its own. This paper has aimed to raise questions about which countries should receive budget support, how much they should receive, and how best to design and manage budget support programmes. These are issues that need to be

analysed, together with work on an agreed set of objectives and principles, in order for budget support to better contribute to the realisation of the Millennium Development Goals and sustained growth and poverty reduction in developing partner countries, and the promotion of closer economic integration and political association elsewhere. Building on the results of this and other work, the Commission will work to improve the approach to the design and implementation of budget support, with a view to more coordinated approaches within the EU.