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Norad

**From earmarked sector support to
general budget support- development
partners' experience**

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Content

1. Introduction	3
2. Aid modalities – a brief discussion on principles	3
The choice of aid instrument.....	3
Aid dependency and incentive structure	4
Sector programmes and sector budget support	4
De-linking sector dialogue and sector funding	6
3. Findings from different development partners	6
DFID	6
<i>DFID Tanzania</i>	7
EU Commission	7
Netherlands	8
Sweden/Sida.....	8
<i>Sida's experience from Rwanda</i>	8
World Bank	9
<i>Uganda</i>	9
<i>Tanzania</i>	10
4. Main findings	11

1. Introduction

The purpose of this report is to discuss the question of how a change of aid modality towards general budget support would affect the dialogue and technical cooperation in the priority sectors, in Norwegian partner countries in general and in Tanzania in particular. The paper focuses on the experience of other donors in this area. The interviews with representatives of EU, DFID, Sida, Netherlands, and the World Bank, has made it clear that the issue of priority sector cooperation and general budget support is under active consideration in many other aid administrations.

2. Aid modalities – a brief discussion on principles

The choice of aid instrument

Development research literature increasingly advocates breaking the link between donor support and specific expenditure programmes. The argument is that developing countries should be defining their own strategies for reducing poverty and for achieving the MDGs through a national political process where poverty is recognized and acted upon. Development partners should provide generic support, using Government's own procedures, to help them implement their strategies. This puts decision-making and responsibility where it belongs, with Governments, it reinforces accountability to domestic political institutions rather than to foreign donors, and it builds sustainable domestic institutions rather than bypassing them. It also reduces the significant management burden of dealing with large numbers of donor projects. The downside is that the donors who are most flexible, most inclined to provide general budget support, will risk being recorded as not providing any significant financial support to priority sector and other key MDGs, despite the fact that they are providing the most flexible, and therefore most valuable, support of all.

The choice of aid instrument for supporting priority sectors is linked to the broader debate on how best to support poverty reduction strategies. A number of studies and assessments into policy and fiduciary requirements for different types of aid have been produced. This research deals with issues of tracking donor flows and more general principles for choosing aid instruments.

In principle, a Government sets its own expenditure priorities through a political process, and then seeks to match those expenditure preferences to the sources of funding that it has available. If the donors have a stronger preference for, for example primary education than does Government, then Government will reduce its own spending in order to ensure that its own priorities get implemented rather than those of the donors. Aid is fungible: - if donors finance sector spending that Government would otherwise have funded from other sources, then the real effect

of the aid is to release Government funds for some other purpose, possibly outside the sector. We cannot therefore assume that aid earmarked for spending on priority sectors actually leads to additional spending on these sectors.

Development cooperation supports a sector both through resources and dialogue. General budget support is often linked to a dialogue regarding allocation of the budget. If Government and general budget support donors reach agreement on either input or indeed output targets related to priority sector, then the aid transaction may be more effective in creating additional spending in the priority sector than more directly targeted support. Spending donor money on priority sector does nothing to guarantee that spending on priority sector increases. The only effective way to ensure that public spending on priority sectors increase is by reaching agreement with Government that more money will be spent on priority sector, and then monitoring that it happens. In addition it is a matter of judgement to determine the baseline level of expenditure against which additional priority sector spending should be assessed, and that baseline will itself increase as economic growth yields increased capacity of the Government to fund priority sectors from domestic resources.

Aid dependency and incentive structure

The choice of aid modality should also take into account the level of aid dependency. In the countries where aid forms a small share of the budget, the transactions costs of transferring funds through projects are manageable and governments might be reluctant to negotiate on policy with donors. Low level of aid dependency also usually means that a large share of public sector resources is fully integrated in national budget process both technically and politically. The incentive problems associated with aid outside the national budget process will therefore vary from extremely important in a country where 30 – 40 percent of the public sector activities are aid financed to insignificant in countries where aid is 5 – 10 percent.

Sector programmes and sector budget support

The sector-wide approach (SWAP) which became popular in the donor community in the mid 1990s was a response to the fragmentation, and perceived limited effectiveness of aid.

Reviews of SWAPs are beginning to emerge. They show benefits in respect of governments' capacity to plan and implement programmes and of donor coordination. Sector-wide approach has helped countries to improve their understanding of problems of service delivery and access by the poor, and the translation of stated sector priorities into resource allocations. SWAPs have increased health sector funding in some (but not all) countries. To a greater extent than previously aid has started to flow through government channels, rather than through channels created by donors to finance "their" projects.

SWAP's have, on the other hand, been criticised for removing responsibility for policies on the sectors away from governments and towards a group of professionals on either the donor or the government's side of the SWAP management team. Evaluations have also pointed at a tendency to centralise the use of resources and setting up very cumbersome financial management arrangements outside the government's own system. The administrative arrangements in many SWAPs therefore became burdensome for the partners.

The background for the SWAPs was very often that along with the need for increased resources to increase service delivery, there was also a need for structural and institutional reforms and capacity building. There was a perceived need to establish and maintain forums for dialogue between the national health and education authorities and the various multilateral and bilateral donors. The dialogue should lead to plans and budgets that direct the use of all donor resources. Donor organisations therefore started to get used to an idea that certain types of aid modality should be linked to certain type of dialogue. Health aid should be linked to health issues dialogue and general budget support should be linked to dialogue and macroeconomic issues and so on.

De-linking sector dialogue and funding

As a response to the criticism of SWAP, efforts to strengthen domestic budget process and the fact that funds are fungible, have led to a discussion among development partners on de-linking the dialogue and the funding of a sector. This can be done by transferring earmarked funds to non-earmarked budget support. An alternative to non-earmarked budget support is notional or virtual earmarking which in reality implies full flexibility on spending for recipient donors.

This move is however questioned both within the agencies and by sector ministries in the recipient countries. There is a concern that total funding to the sector will decrease and that development partners will have little influence in the sector dialogue. As general budget support is less predictable than other aid modalities, both recipient governments and donors fear that funding will be more volatile which will have a negative effect on both service delivery and macroeconomic stability.

3. Findings from different development partners

Below is a brief review of the position of some other donors. The information is compiled through interviews and written documents. A list of people interviewed and relevant documents is attached.

DFID

DFID has made a clear policy commitment to use general budget support in the cooperating countries that meet a set of economic, governance and other criteria. This is considered to be a generic policy issue. DFID considers the use of budget support to be much more important in countries where aid forms a large share of the overall financing of the public sector. They are however conscious of the danger of budget support easily becomes a more politicised form of aid and governance issues such as corruption can lead to unwanted stop and go in disbursement of aid. This means that budgets support is considered the right option in Tanzania but not necessarily in a country like Bangladesh.

DFID emphasises the need to use the governments own monitoring system in terms of poverty outcomes and that a useful Public Expenditure Review (PER) system is in place. The shared system is important to make monitoring as effective and coordinated as possible and to let the monitoring form the basis for the political dialogue inside and outside the country in question. The PER is important to constantly monitor the overall budget allocations towards priority and non-priority sectors and to have a basis for meaningful dialogue on budget support.

The DFID representatives stated very clearly that the different development partners must learn to trust each other more in the sector dialogue work. There is little point in having many donor representatives duplicating each other's work in sector working groups.

The move from earmarked to non-earmarked sector support has not changed the level of staffing in the field offices. However, in some field offices, former sector specialists have been replaced by economists, monitoring specialists and governance experts.

DFID has almost entirely abandoned notional earmarking of budget support. Due to internal regulation that is not changed, they used to do that in many countries. The most common rule was to reimburse the outlays towards teachers' salaries, which typically is one of the biggest expenditures on developing countries' budgets.

On the other hand DFID is now actively considering starting using graduated response system which would mean that a part of the budget support is clearly linked to the achievement of a certain quantifiable goal within the social sector.

While budget supports contribute to improved service delivery in social sectors, this is not recognized by the current OECD/DAC statistical classification. This is considered as a problem that needs to be addressed.

DFID Tanzania

DFID is the only donor in Tanzania that has transferred all sector budget support to general budget support. However, DFID still participate actively in the sector dialogue in health and education. DFID's health and education advisers have been replaced by one adviser covering both sectors and who is responsible for linking cross-cutting issues like local government reform, poverty reduction monitoring to the sector dialogue.

EU Commission

The EU is fast becoming one of the biggest budget support donors in Africa. On the technical level the Commission is presently working to develop a policy on what should be the relationship between general budget support and sector budget support. This work will be presented in a policy report in the near future. What seems already decided is that the former system of re-imbursing certain expenditures (as with DFID and teachers salaries) would not be continued. The system of variable tranches released on the basis of performance in public financial management and social sector performance, is to be continued.

The representative interviewed indicated that he thought the EU would maintain both general and sector budget support as terms used in their cooperation programmes but that the actual difference between the two might be relatively small. Both would use the treasury in the receiving country for channeling and accounting for funds and both would consist of one main and some variable tranches. The main difference would be as it now looks, that the sector support would be linked to some form of additionality. That means that there would be an indicator to measure actually increased expenditures. It is however recognised that this is relative difficult to do in practical terms.

The Commission representative indicated that they held the view that sector dialogue in many cases is of limited value and that donors should be more critical of their own role. This is probably a debated issue within the commission. The main policy view is that using the outcome indicators as dialogue issues and triggers of variable tranches is a more effective way of influencing policy. He however added that donors should be willing to provide additional funding for technical assistance and cooperation.

The treatment of general budget support in OECD DAC statistics is being hotly debated in the commission. There are two views. One is based on a paper presented by Mick Foster which argues that general budget support should be counted as support to the various sectors according to the sectors share of overall budget

resources in the country. The other is to use “poverty oriented Budget support” as a new line in the statistics.

Netherlands

The Dutch experience in this field is considered rather limited and the Ministry of Foreign Affairs in the Netherlands advised us to interview their Embassy in Kampala to get their experience on these issues.

The Dutch budget support agreement with Uganda contains notional earmarking to education, and the judicial and legal sector programme (JLOS). This has replaced earlier earmarked support to the education sector. There are three tranches in the Dutch budget support to Uganda. 30 pct. of the total annual tranche is linked to general performance, 20 pct. is linked to performance in the judicial sector and 50 pct. is linked to reaching specific goals in the education sector. Triggers for the notional earmarked support to the two sectors are specified in the WB’s PRSC policy results matrix.

Sweden/Sida

Sweden’s budget support programmes is only indirectly handled by Sida and formally decided by the Ministries of Foreign Affairs in consultation with the Ministry of Finance and based on direct allocation made by Riksdagen. It is expected that budget support soon will be joined in with the rest of Swedish aid programmes under Sida.

Sida is just now debating the link between sector support and sector dialogue. There is a felt need to change the perspective away from discussions amongst the donors and in the direction of the national policy development in each country. The Sida representatives indicated that they increasingly view a combination of budget support and SWAPs in the same country as inefficient. The crucial issue is to stimulate the development of an improved budget process.

Sida is according to our contacts likely to increase the overall level of budget support by also transferring funds from sector level to general budget support, and do not see the possible loss of sector dialogue as a major problem that need to be addressed. Their main concern is that the dialogue on sector issues should be coordinated with the overall dialogue and the country programme they work within.

In some countries, like Tanzania, Sida is considering variable tranches linked to performance in public financial management and social sectors.

Sida’s experience from Rwanda

Sida’s only experience in providing notional earmarked support to a sector is in Rwanda where Sida provides support to the education sector through a silent partnership arrangement with DFID. DFID’s financial support to education is

provided as part of general budget support to Rwanda, which started in 2002, with co-financing from Sida.

General budget support monitoring framework includes indicators and targets for the education sector. Monitoring of the targets is done through annual reviews that also assesses progress towards PRS targets and provides input to MTEF and annual budget process.

The intention for Sida was to delegate monitoring of the education sector to DFID, rely on their reports and be informed through annual meetings with DFID. Since there were few donors in the education sector in Rwanda, DFID requested Sida to participate in the annual sector reviews. DFID is however responsible for day-to-day follow up and has one full time education adviser stationed in Rwanda. Budget support is complemented with short and long term technical advisers in the education ministry.

Sida sees a good monitoring system and an well functioning expenditure tracking system as essential for de-linking sector financing and sector dialogued, of which both are in place in Rwanda.

Sida's assessment of Rwanda funding model is positive. Moving education financing to budget support has not reduced total budget allocation to the education sector. The dialogue has changed to more emphasis on budget process and allocation of funds.

World Bank

Uganda experience

WB generally provides sector support in different ways; sector adjustment loan (SAL), investment projects and budget support (PRSC). The financial modality differs from country to country and is decided by assessing among others fiduciary risk, budget transparency. WB has not defined an assessment format and practice will differ from country to country depending on assessment of field staff. The Development Policy Lending recently approved by WB implies high degree of delegation and decentralisation of authority to field offices. This opens for a different approach in different countries. In some countries a direct financing (earmarking) is considered best option. A well-developed government sector program, good sector dialogue, and transparent budget process are seen as important criteria for financing sectors through budget support.

In Uganda, PRSC is the World Bank's main instrument for supporting the government's reforms in health, education and water and sanitation. All Bank's assistance to education and water and sanitation is channeled through PRSC, while in health self-standing investment projects are providing support in parallel.

Impact of PRSC is monitored within the overall PEAP/PRSP monitoring arrangements. Implementation of the PEAP is done jointly by Government of Uganda (GoU), development partners and civil society. For education, health, water and sanitation and other sectors (justice, law and order), GOU has established consistent set of monitoring indicators, quantitative targets for inputs and outputs which are tracked at regular intervals. Subset of key indicators is included in PRSC quantitative target matrix. To collect data on indicators and monitor process; education, health and water and sanitation sectors have established management information systems. In addition, all these sector conduct annual expenditure-tracking surveys to monitor flow of funds, and value for money studies becomes common. In the annual review, Government and development partners assess performance of each sector, discuss emerging issues, and agrees on new undertakings and quantitative targets.

PRSC has prior actions¹ for the three mentioned sectors which states satisfactory implementation of undertakings agreed in the sector review. The Government's letter presented to WB as part of application for PRSC support, reports on progress and steps taken to follow up the reviews. The letter states that the reviews continue to be the main forum for agreeing undertakings for budget allocation and monitoring progress.

Some view sector prior actions as a guarantee for sector progress. By financing government's sector programme through PRSC, funding for the sector will however depend on factors not related to sector performance. That is a concern raised in the Bank and is addressed in the ongoing discussion on graduated response.

The Stock-taking review of PRSC done in 2003/04 states that cross-cutting actions are more successful dealt with when included in PRSC than in sector programs. In education, an example is the interlinked program of teacher recruitment and deployment, textbook publishing and classroom construction, for which responsibility falls within three separate ministries, all outside Ministry of Education and Sports. As a result many ministries have attempted to have their cross-cutting goals included in PRSC policy matrix.

Shifting sector financing to PRSC has had no impact on staff and workload. The Uganda field office has one full time employee on education and one health in addition to Washington based staff.

Tanzania experience

WB joined the bilateral donors' budget support facility, PRBS, with its first PRSC in 2002. The World Bank feels that the forthcoming joint assistance Strategy (JAS) will state very clearly that general budget support will be the main instrument for

¹ Triggers for PRSC disbursement

development support. This is a response to sector program weaknesses and is a response to Government of Tanzania's (GoT) request.

WB provides support to the education SWAP (Primary Education Development Programme; PEDP) with a Structural adjustment loan. After closure of the project next year, financial support to education will be given as increased PRSC. A new sector adjustment credit for Secondary Education development program is under preparation. This will run for 3 years and then be shifted to PRSC.

WB's support to health is provided through Adjustment Project Loan (APL). Disbursement to the project will decrease over next 3 – 4 years while support through PRSC will increase. In this period Ministry of Finance's allocation to health will be closely monitored to ensure that total health budget does not decrease. In addition more APL funds will be channeled through the health SWAP basket.

4. Main findings

Few donors have experience from de-linking sector support and sector dialogue. This is however a highly debated topic in most agencies and one would anticipate a substantive move in this direction by many donors in the coming years. EC, Sweden and other like-minded donors are "struggling" with the same issues and are eager to discuss challenges and options with other development partners.

The relationship between dialogue on priority sector issues and the move towards general budget support as aid modality differs from country to country. It is therefore difficult to provide generic answers and define a common approach in the countries where Norway is involved as a main development partner. The main impression from other donors' experiences seems to be that there is a good possibility of maintaining a sector level dialogue in combination with a budget support aid modality. What appears to happen in most cases is a combination of two factors. Firstly, the general budget support dialogue "takes over" many of the policy and cross-cutting dialogue issues that were previously discussed in sector programme working groups. Secondly, administrative resources in donor agencies are freed to be more involved in output and outcome related issues in the sector.

It is furthermore evident that there is an ongoing convergence of issues in the dialogue linked to budget support and traditional social sector dialogue. The macro dialogue has become more focused on PRSPs, poverty outcomes and governance, while sector dialogues have increasingly become involved in issues such as civil service reform and public sector financial management.

Both the interviews with other donors and the (still relatively limited) research literature in this field indicate, however, that it is important to clarify a number of issues:

- What is it we want to see emerge as a result from a particular priority sector dialogue that is not captured in an overall policy oriented dialogue on PRSPs? Is it more detail on the same issues or different issues? SWAP dialogue has often involved tracking of funding and total sector allocations and reviews of indicators of service delivery. All these elements are key elements in typical macro dialogue processes such as Public Expenditure Reviews (PER) and poverty monitoring through household surveys.
- Could more be achieved by establishing reporting procedures from priority sectors to the PRSP and budget support dialogue? Such an integration of reporting can take different forms in different countries, and could support the country's own budget and policy-making processes.
- How will choice of aid modality, monitoring systems and dialogue forums etc affect different stages and aspects of the budget process from monitoring through planning, policy making and implementation to accounting and auditing? There is increasing awareness that the key challenge very often is to re-establish an effective budget process after many years of very fragmented donor support.

Experience of development partners de-linking dialogue and funding is so far only from sectors like education and health. Development partners' consider such sectors as good candidate for budget support financing, while cross-cutting reforms like local government and public financial management reforms are considered more suitable for common basket funding.

The treatment of general budget support in OECD DAC statistics is a concern for all the donors interviewed. Both DFID and EC are considering different options. One option is to count part of budget support as support to the various sectors according to the sectors share of overall budget resources in the country. The other is to use "poverty oriented budget support" as a new line in the statistics. The second option seems to be preferred. Notional earmarked budget support is however reported as sector support to DAC, which could be seen as an argument for donors to provide notional earmarking.

The worry that a move to non- earmarked funding can exclude partners from sector dialogue can be addressed in different ways. One option is to include sectors in the budget support monitoring framework, which is done by World Bank. Another option is to state in joint government – donor partnership principles that all development partners, whatever the modality of their assistance, are invited to take part in sector dialogue and sector reviews. This is done in Uganda (Partnership Principle signed September 2003).

The World Bank model of including sector specific actions as triggers for disbursement of budget support is viewed by many as a guarantee for sector progress. In the present model, funding to the sectors is however depended on triggers not related to sector performance. That is a concern raised in the Bank and has led to a discussion in Uganda on a graduated response so ensure disbursement to sectors based solely on their performance.

Both the EC model of variable tranches dependent on sector performance, graduated response focusing on sector performance, and stronger focus on output and outcome targets in budget support monitoring matrix, implies a strong link between sector dialogue and budget support. Most donors interviewed assess sector involvement to be an essential part of budget support as the objective of budget support is to implement PRS and contribute to an achievement of MDGs.

None of the interviewed development partners have established criteria to decide when funds for sectors should be provided as budget support. WB staff indicated assessment of fiduciary risk, budget transparency, maturity of sector programs and quality of sector dialogue as important areas for consideration. The high degree of delegation and decentralisation of authority to field offices facing most development partners, opens for a different approach in different countries.

Experience shows that sector policy issues and cross-cutting actions are more successful dealt with when included in a budget support facility than in sector programs.

Shifting sector financing to budget support has had no impact on staff and workload for development partners' field offices. The content of the dialogue has however shifted to more focus on fact-finding, poverty monitoring and budget issues.